Budget 2004

Annex 9
Tax Measures: Supplementary Information

Overview

This annex provides detailed information on each of the tax measures proposed in the budget. Table A9.1 lists those measures that are proposed to be legislated pursuant to the 2004 budget and provides estimates of their budgetary impact. This annex also provides Notices of Ways and Means Motions to amend the Income Tax Act, the Excise Tax Act and the Income Tax Conventions Interpretation Act.

Table A9.1
Federal Revenue Impact of Proposed Tax Measures

	2003–2004	2004–2005	2005–2006
	(millions of dollars)		
Income tax measures			
Tax fairness for persons with disabilities[1]	–	15	15
Caregiver expenses	–	20	25
Education tax credit	–	5	10
Small business deduction limit	–	–	20
Refundable SR&ED investment tax credit—expenditure limit	–	–	–
Carry-forward period for business losses	–	–	–
Capital cost allowance rates for computers and data network infrastructure equipment	–	110	255
Mineral exploration tax credit	–	–	10
Fines and penalties	–	–	–
Income trusts	–	-15	-55
General anti-avoidance rule	–	–	–
Affiliated persons rules and trusts	–	–	–
Patronage dividends	–	–	–
Taxpayer-requested adjustments	–	–	–
Trading charitable donations	–	–	–
Notices served on a financial institution	–	–	–
Registered charities—regulatory reforms	–	12	12
Tax relief for Canadian Forces personnel and police deployed to international high-risk operational missions	–	30	30
Sales and Excise Taxes			

GST/HST rebate for municipalities	100	580	605
Other Measures			
Canada Learning Bond	–	85	85
Canada Education Savings Grant	–	20	80
Taxation arrangements with First Nations	–	–	–
Total	100	862	1,092

[1] Funded from monies allocated in Budget 2003.
– Small, non-existent or prevents revenue loss.

Income Tax Measures

Tax Fairness for Persons with Disabilities

Work of the Technical Advisory Committee on Tax Measures for Persons with Disabilities

The Technical Advisory Committee on Tax Measures for Persons with Disabilities was established in 2003 to advise the Minister of Finance and the Minister of National Revenue on ways to improve tax fairness for persons with disabilities and those who care for them. To date, the Committee has identified a number of key areas of concern, including:

- The eligibility criteria for the disability tax credit (DTC).
- Barriers to employment and education for persons with disabilities.
- The adequacy of tax measures for caregivers.

With respect to the eligibility criteria for the DTC, the Committee believes that the revised DTC certification form released by the Canada Revenue Agency earlier this year addresses many of the concerns expressed by the community of persons with disabilities, specifically the eligibility of individuals with mental impairments. Going forward, the Committee will examine options for further improvements to the eligibility criteria and administrative procedures.

Reducing Barriers to Employment and Education: A New Disability Supports Deduction

Currently, persons with disabilities may receive tax relief for the cost of disability supports for employment and education through the attendant care deduction or the non-refundable medical expense tax credit (METC).

However, persons with disabilities may pay tax on the income, including government assistance, used to purchase disability supports that are claimed under the METC (see box for an example).

In examining barriers to employment and education for persons with disabilities, the Committee has proposed that disability supports purchased for purposes of employment or education be fully deductible, in a manner similar to that of attendant care expenses. In response, Budget 2004 proposes to replace the attendant care deduction with a broader disability supports deduction, which 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 (e.g. insurance payment).

Tax Treatment of Disability Expenses

Chris is a student living in New Brunswick who has a taxable income of $17,000 (comprised of scholarships and earnings from a part-time job). He has a severe hearing impairment and needs a sign-language interpreter in order to attend university. He has received an additional $5,000 from a *Canada Study Grant for Students with Permanent Disabilities* that he uses to purchase sign-language interpretation services to attend class, giving him a total income of $22,000 subject to tax.

Existing Rules

Under the current rules, Chris would pay some income tax on the government assistance, even if it were fully used to purchase disability supports necessary for him to attend school:

Amount of *Canada Study Grant* included in income		$5,000
Less: Gross federal tax on the grant ($5,000 X 16%)		-800
Gross provincial tax on the grant ($5,000 X 9.68%)		-484
Plus: METC recognition	$5,000	
Less: 3% threshold (3% of $22,000)	-660	
Claimable expenses	$4,340	
Federal tax relief ($4,340 X 16%)		+ 694
Provincial tax relief ($4,340 X 9.68%)		+ 420
Amount of the grant left after taxes		**$4,830**

In order to cover the $5,000 in sign-language fees, Chris must pay $170 ($5,000-$4,830) out of his own pocket. If Chris were receiving income-tested benefits, he might pay even more from his own pocket since those income-tested benefits could be reduced.

Proposed Rules

With the proposed disability supports deduction, Chris will receive an offsetting deduction equal to the amount of the grant he received to pay for the sign-language interpreter fees. Thus, in this case, Chris' taxable income will remain at $17,000, which means that he will pay no income tax on the grant he received and that his eligibility for income-tested benefits will not be affected.

The deduction will be based on the existing limits for the attendant care deduction, except that there will be no two-thirds factor applied. For example, in the case of an employee, the deduction will be the lesser of amounts paid for eligible expenses and earned income.

The list of eligible disability supports expenses will be limited to amounts paid for:

- Sign-language interpretation services used by individuals who have a speech or hearing impairment (and paid to persons engaged in the business of providing such services).
- Real-time captioning services used by individuals who have a speech or hearing impairment (and paid to persons engaged in the business of providing such services).

- Teletypewriters or similar devices that enable deaf or mute individuals to make and receive phone calls.

- Devices or equipment designed exclusively to be used by blind individuals in the operation of a computer (e.g. a Braille printer or a large-print on-screen device).

- Optical scanners or similar devices designed to be used by blind individuals to enable them to read print.

- Electronic speech synthesizers that enable mute individuals to communicate by use of a portable keyboard.

Further, amounts paid for the following services or devices will also be eligible for the deduction if the need for those services or devices has been certified by a medical practitioner:

- Note-taking services used by individuals with mental or physical impairments (and paid to persons engaged in the business of providing such services).

- Voice-recognition software used by individuals with a physical impairment.

- Tutoring services used by individuals with a learning disability or a mental impairment (and paid to persons engaged in the business of providing such services).

- Talking textbooks used by individuals with a perceptual disability in connection with the individual's enrolment at a secondary school in Canada or designated educational institution.

- Attendant care services provided in Canada used by individuals with a mental or physical infirmity (and paid to persons who are not the taxpayer's spouse or common-law partner or under 18 years of age).

The effect of the new deduction will be that no income tax will be payable on income (including government assistance) used to pay for these expenses, and that this income will not be used in determining the value of income-tested benefits.

Expenses claimed under the disability supports deduction will not be claimable under the METC. Individuals who purchase disability supports for purposes other than education or employment will still be able to claim them under the METC.

This deduction will apply to the 2004 and subsequent taxation years.

Consequential to this proposal, the value of the refundable medical expense supplement (RMES) will for the 2004 and subsequent tax years be equal to 25 per cent of allowable expenses claimed under the METC plus the new disability supports deduction, up to a maximum limit of $562 for 2004, indexed for future years. This will ensure that individuals who previously claimed the cost of disability supports under the METC and consequently received the RMES will not see the amount of their RMES reduced if they claim the expenses under the new disability supports deduction.

In addition, consequential amendments to the Income Tax Regulations will be made regarding the eligibility of talking textbooks for the METC to ensure that the eligibility requirements for that expense are consistent for both the proposed deduction and the METC.

Caregiver Expenses

Taxpayers paying medical or disability-related expenses on behalf of a spouse, common law partner or dependent relative may claim those expenses under the medical expense tax credit (METC). For the purposes of the METC, a dependant is defined as a child, grandchild, parent, grandparent, brother, sister, uncle, aunt, niece or nephew who is dependent on the taxpayer for support.

Currently, medical expenses incurred on behalf of a spouse or common law partner may be claimed to the extent that, together with the taxpayer's other medical expenses, they exceed the taxpayer's minimum expense threshold, that is, the lesser of 3 per cent of the taxpayer's net income and $1,813. However, in the case of a claim on behalf of a dependent relative, the amount of medical expenses claimable by a supporting relative is reduced by 4.25 times the amount by which the dependent relative's net income exceeds the basic personal amount ($8,012 for 2004). This restriction, which is often referred to as the notch provision, results in a sharp reduction in the amount of medical expenses that a supporting relative can claim.

Budget 2004 proposes to allow caregivers to claim more of the medical and disability-related expenses that they incur on behalf of dependent relatives.

Specifically, medical expense claims made on behalf of minor children will be pooled with the medical expenses of the taxpayer and his or her spouse or common-law partner, subject to the taxpayer's minimum expense threshold (the lesser of 3 per cent of the taxpayer's net income and $1,813), without regard to the income of the minor child.

For medical expenses paid on behalf of other dependent relatives (e.g., grandparent, niece, nephew, etc.), taxpayers will be able to claim qualifying medical expenses paid on behalf of such a dependant that exceed the lesser of 3 per cent of the dependant's net income and $1,813 (that is, the threshold for the METC that would apply if the dependant claimed the expenses). The maximum eligible amount that can be claimed on behalf of dependent relatives other than minor children will be $5,000.

The current rules for determining dependency will continue to apply. If an individual is dependent on his or her spouse or common-law partner, no other supporting relative will be able to claim medical expenses they incurred on behalf of that individual.

Tax Recognition of Medical Expenses Paid by Caregivers

Michelle provides support to her adult son, Warner, who has a disability. Warner has a part-time job and earns $10,000 annually. However, Michelle pays all of Warner's medical expenses, which are $4,000 a year. Michelle currently has a net income of $50,000.

Existing Rules

Under the current rules, Michelle would not be able to claim any of Warner's medical expenses, as shown below:

Medical expenses incurred on behalf of Warner	$4,000

Less: 3% of Michelle's net income ($50,000 X 3%)		-1,500
Amount of claim before notch provision		2,500
Notch provision:		
Warner's net income	$10,000	
Basic personal amount	-8,012	
Warner's net income in excess of basic personal amount	1,988	
Amount medical expense claim reduced ($1,988 X 4.25)		-8,449
Net medical expense claim (current rules)		0
Proposed Rules		
Under the proposed rules, Michelle would be able to claim $3,700 of Warner's medical expenses, for a federal income tax reduction of $592, calculated as follows:		
Medical expenses incurred on behalf of Warner		$4,000
Less: 3% of Warner's net income ($10,000 X 3%)		-300
Net medical expense claim (proposed rules)		$3,700
Federal income tax reduction ($3,700 X 16%)		$592

This measure will apply to the 2004 and subsequent tax years.

Education Tax Credit

The education tax credit is provided in recognition of non-tuition costs of post-secondary education, such as the cost of textbooks. The education amounts, upon which the education tax credit is calculated, are $400 per month of full-time study and $120 per month of part-time study.

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 lifelong learning, the Budget proposes to remove this restriction provided that no part of the costs of education is re-imbursed by the employer.

This measure will apply to the 2004 and subsequent taxation years.

Small Business Deduction Limit

The small business deduction reduces the basic federal corporate income tax rate to 12 per cent for the qualifying amount of active business income of a Canadian-controlled private corporation (CCPC). This provision helps small CCPCs retain more of their earnings for reinvestment and expansion. The maximum annual amount of active business income qualifying for the reduced 12-per-cent tax rate is the small business limit. Budget 2003 implemented a phased increase in the small business 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.

In order to provide additional support to small business, Budget 2004 proposes that the increase in the small business limit to $300,000 be accelerated by one year. The small business limit will therefore be $300,000 in 2005 and subsequent years.

The small business limit will be pro-rated where the taxation year of the corporation does not coincide with the calendar year. In addition, there will continue to be a requirement to allocate the small business limit among associated corporations, and the limit will continue to be reduced on a straight-line basis for CCPCs having between $10 million and $15 million of taxable capital employed in Canada.

Refundable SR&ED Investment Tax Credit—Expenditure Limit

For small Canadian-controlled private corporations (CCPCs), the scientific research and experimental development (SR&ED) investment tax credit (ITC) is available at an enhanced rate of 35 per cent instead of the general 20-per-cent rate. Unused portions of the SR&ED ITC earned at the 35-per-cent rate are fully or partially refundable, which can result in an annual refund of up to $700,000.

The amount of SR&ED expenditures that earn tax credits at the 35-per-cent rate is referred to as the expenditure limit. The expenditure limit for a taxation year of a CCPC is generally $2 million, subject to reduction where the CCPC's taxable income is over $300,000 or taxable capital is over $10 million.

CCPCs that are controlled (in law or in fact) by the same person or group of persons are considered to be associated corporations. Associated corporations must share the annual $2 million expenditure limit for the purposes of computing the refundable SR&ED ITC. The phase-out of the expenditure limit is also based on the combined taxable income and taxable capital of a group of associated corporations. The policy intent of these provisions for associated corporations is to prevent the multiplication of the expenditure limit by corporations controlled by the same person or group of persons.

However, the associated corporation rules in the Income Tax Act may cause unintended results for some research and development intensive CCPCs that are considered to be associated solely because of independent investments made in the corporations by the same group of otherwise unconnected investors, such as venture capital investors. This is because, under the associated corporations rules, two or more persons who own shares of a corporation are considered to be a group of persons independent of any other factor.

As the refundable SR&ED ITCs are an important source of additional working capital for these businesses, the application of this requirement can result in a higher cost of working capital, which in turn can diminish growth prospects.

To remove this impediment to small business accessing SR&ED assistance if they also raise funding from common investors, the budget proposes to amend the refundable SR&ED ITC rules. Small CCPCs that have a group of common investors (which group the Minister of National Revenue is satisfied was not formed to gain access to multiple expenditure limits) will not have to share the $2 million expenditure limit solely because two or more investors collectively have a majority interest in the shares of each corporation. Each small business will, in such a case, have access to its own $2 million expenditure limit, thus continuing to provide each business with access of up to $700,000 in SR&ED assistance.

This change will apply to taxation years that end after March 22, 2004.

Carry-Forward Period for Business Losses

The Income Tax Act measures and taxes income on an annual basis but provides for the recognition of losses from other taxation years in order to improve fairness and market efficiencies, and to recognize the effects of business cycles. Without such recognition, a business with stable profits could pay less tax over a given period of years than a business whose total profits for the period were the same but that experienced losses in some of those years. This in turn could make activities that generate stable income streams more attractive to entrepreneurs and investors than activities with greater volatility.

Taxpayers may use losses to reduce their tax liability in earlier and later taxation years, subject to certain limits and conditions. Those limits and conditions largely depend on the character of the particular loss, with different rules applying to what are defined as, for example, non-capital (business) losses, limited partnership losses, farm losses, restricted farm losses, ordinary capital losses, allowable business investment losses, and capital losses on listed personal property—artworks, jewellery and the like.

The carry-over period for non-capital losses can be especially important for small businesses. It is common for a new enterprise, particularly a smaller one, to experience several years of losses during its start-up phase. Currently, non-capital losses may be carried back three years and forward seven taxation years from the year in respect of which they arose. Even with a seven-year carry-forward period, many small business taxpayers are unable to fully utilize their losses before they expire. For example, in 2002 there were more than 24,000 small businesses which had losses that expired.

The budget proposes to extend the loss carry-forward period for non-capital losses from 7 to 10 years. In addition to improving fairness and smoothing out the impact of business cycles, extending the non-capital loss carry-forward period to 10 years will harmonize it with the periods already applicable to farm losses and restricted farm losses.

Budget 2004 also proposes to extend to 10 taxation years the carry-forward periods for:

- The application of unused foreign tax credits under Part I of the Act.
- The application of non-capital losses under Part IV of the Act.
- The application of a life insurer's taxable Canadian life investment losses under Part XII.3 of the Act.

This measure applies to losses and credits that arise in taxation years that end after March 22, 2004.

The following table shows the current loss carry-forward periods that apply to different kinds of non-capital losses, and how these will change as a result of this measure. It should be noted that a taxpayer can generally choose to carry a loss back up to three taxation years, instead of carrying it forward. As well, in certain cases carry-overs are limited as to amount or subject to other special conditions.

Table A9.2
Carry-Forward Period (Taxation Years)

Loss	Current	Proposed
Non-capital losses (general)	7	**10**
Non-capital losses (applied under Part IV)	7	**10**

Farm losses	10	10
Restricted farm losses	10	10
Taxable Canadian life investment losses	7	**10**
Limited partnership losses	unlimited	unlimited

Capital Cost Allowance Rates for Computers and Data Network Infrastructure Equipment

Budget 2003 stated that the Government would review aspects of the tax structure to improve the efficiency of the tax system and strengthen the Canadian tax advantage for investment. One area in which the tax system has an important impact on investment is the treatment of capital property.
A portion of the capital cost of depreciable property is deductible as capital cost allowance (CCA) each year, with the maximum CCA rate for each type of property set out in the Income Tax Regulations. Improving the CCA rate structure can enhance productivity through an increase in total investment and a more efficient allocation of investment across asset classes.

Economic analysis shows that taxes on savings and investment have the largest impact on efficiency and living standards. Adjustments to capital cost allowances to better reflect the useful life of assets can have a particularly large impact on investment and income because they can be designed to affect the after-tax return on new investment only.

Capital Cost Allowance

- Capital cost allowance (CCA) is a deduction for tax purposes that recognises the depreciation of capital property. The CCA rate for an asset determines the portion of the cost of the asset that can be deducted each year (generally on a declining balance basis).
- CCA rates are generally intended to reflect the economic consumption over time of capital property. The deduction for CCA is based on the principle that depreciable capital assets are not consumed in the period in which they are acquired, but instead contribute to earnings over several years. Therefore, the cost of depreciable assets should be allocated over the entire period that the asset contributes to earnings—that is, the asset's useful life.

The CCA rate for an asset should, as a general principle, reflect the useful life of that asset and thus provide adequate recognition of capital costs. In this way, CCA rates do not distort investment choices—they will instead lead to a more efficient allocation of resources in the economy.

The useful life of assets can change over time for several reasons, including technological change. The Government's assessment of CCA rates is therefore an on-going process. As part of this continuing review, the budget proposes adjustments to CCA rates for computer equipment and data network infrastructure equipment.

The Government will continue to assess the appropriateness of capital cost allowance rates which, as a general principle, should reflect the useful life of assets.

Computer Equipment

Currently, computer equipment is generally eligible for a 30-per-cent CCA rate.

Current CCA Treatment
Computer equipment is described in Class 10 of Schedule II to the Income Tax Regulations as general-purpose electronic data processing equipment and systems software therefor, including ancillary data processing equipment but not including property that is principally or is used principally as:
(i) Electronic process control or monitor equipment.
(ii) Electronic communications control equipment.
(iii) Systems software for a property referred to in subparagraph (i) or (ii).
(iv) Data handling equipment unless it is ancillary to general-purpose electronic data processing equipment.

A review of the CCA rate for computers indicates that a higher CCA rate would better reflect the useful life of these assets. The budget, therefore, proposes to increase the CCA rate for computer equipment acquired after March 22, 2004, to 45 per cent from 30 per cent. The current exemption for computers from the specified leasing property rules will be extended to computer equipment eligible for this higher CCA rate, other than any individual item with a capital cost in excess of $1 million.

Separate Class Election

Currently, certain equipment, including computer equipment, is eligible for a separate class election. The separate class election, which must be made for the taxation year in which a property is acquired, allows taxpayers to place eligible property in a separate class for CCA purposes. Although the separate class election does not change the CCA rate specified for the class, it does provide that upon the disposition of the property of that class, any remaining undepreciated balance can be fully deducted as a terminal loss, instead of remaining in a pool with other assets and being depreciated over time. With the proposed higher rate for computer equipment, the separate class election is no longer required. Accordingly, it is proposed that the separate class election provisions not be available to computer equipment eligible for the higher rate.

To accommodate taxpayers who may have already planned purchases based on the availability of the separate class election, it is further proposed that, for computer equipment acquired before 2005, taxpayers may elect to have the property included in Class 10 and therefore eligible for the separate class election. The proposed election must be filed with the income tax return for the taxation year in which the property is acquired.

Data Network Infrastructure Equipment

Currently, data network infrastructure equipment is generally depreciated at a 20-per-cent CCA rate.

Current CCA Treatment
Class 8 (20-per-cent CCA rate) of Schedule II to the Income Tax

Regulations includes tangible capital property that is not included in another class. Because most broadband, Internet and other networking technology did not exist until recent years, data network infrastructure equipment is not expressly identified in Schedule II. As a result, it falls under Class 8.

Data network infrastructure equipment is infrastructure equipment that supports advanced telecommunications applications such as e-mail, Web searching and hosting, instant messaging and audio- and video-over-IP (Internet Protocol). It includes assets such as switches, multiplexers, routers, hubs, modems and domain name servers that are used to control, transfer, modulate and direct data, but does not include office equipment such as telephones, cell phones or fax machines, equipment such as web servers that are currently considered to be computer equipment, or property such as wires, cables or structures.

A review of the CCA rate for data network infrastructure equipment indicates that a higher CCA rate would better reflect the useful life of these assets. Budget 2004 proposes that data network infrastructure equipment acquired after March 22, 2004 be included in a new class, with a 30-per-cent CCA rate.

Equipment eligible for this higher rate will include only data network infrastructure equipment that is currently included in Class 8 because it is not included in any other CCA class.

Mineral Exploration Tax Credit

In October 2000 the Government introduced a temporary tax credit for mineral exploration to moderate the impact of the global downturn in exploration activity on mining communities across Canada. The credit provides individuals with an additional tax incentive related to the purchase of certain flow-through share investments. Flow-through shares facilitate the financing of exploration by allowing companies to transfer unused income tax deductions to investors. The credit is equal to 15 per cent of specified grass roots mineral exploration expenses incurred in Canada by a corporation and renounced to an individual under a flow-through share agreement.

The 2003 budget announced an extension to the scheduled expiry date of the credit by one year to December 31, 2004. It also removed a restriction that had made the flow-through share look-back rule unavailable for the final year of the credit. As a result of the 2003 budget measure, funds raised from an individual under a flow-through share agreement in 2004 can be expended by a corporation up to the end of 2005 and be eligible for the credit as a deemed expense of the individual in 2004.

Although market conditions for mineral exploration have improved since the credit was introduced, Budget 2004 proposes to establish in legislation an expiry date for the credit of December 31, 2005 in order to provide companies with ample time to plan their transition from the credit. Under the look-back rule, this will allow eligible expenses to be incurred up until the end of 2006.

Mineral exploration activity will continue to benefit from the availability of flow-through share financing and the new corporate mineral exploration tax credit, which was introduced as part of the income tax changes for the resource sector announced in Budget 2003.

Mineral exploration activity, including that facilitated by the credit, is subject to applicable federal and provincial environmental regulations. Any new mining project arising from that exploration would also be subject to regulation including, in most cases, project-specific environmental assessment.

Fines and Penalties

The Income Tax Act generally permits a taxpayer to deduct, in computing income from a business or property, expenses incurred for the purpose of earning that income. Recent jurisprudence has held that deductibility generally extends to fines and penalties incurred in the ordinary course of earning income, unless the underlying action or omission was so egregious or repulsive that the fine or penalty could not reasonably be considered to have had an income-earning purpose.

Many countries with similar income tax systems to Canada rely either on a statutory prohibition to the deductibility of fines and penalties or on jurisprudence that provides the same result. It is generally recognized that to allow a deduction for a fine or penalty that has been imposed in respect of a particular act or omission by a taxpayer, diminishes the disincentive to engage in that activity. Generally, therefore, such a deduction is contrary to overall public policy objectives.

Concerns have been raised concerning the deductibility of fines and penalties, based upon the current legislation, administrative practice and jurisprudence. In order to provide certainty in this area of the tax law, and to achieve an appropriate result, the budget proposes to deny the deductibility of any fine or penalty imposed by law—whether by a government, government agency, regulator, court or other tribunal, or any other person with statutory authority to levy fines or penalties. This would include fines and penalties imposed under the laws of a foreign country.

The federal, provincial, municipal or foreign law under which an amount is required to be paid will determine whether the amount may be deductible: if it is not characterized as a fine or penalty, the amount may be deductible if it is otherwise incurred for the purpose of earning income; if it is characterized as a fine or penalty, the amount will not be deductible. This proposal would not apply to penalties or damages paid under a private contract.

It is proposed that legislation to implement this measure include authority to exempt prescribed fines and penalties from its application. This regulatory authority is intended to be used only if situations are identified in which it would be inconsistent with public policy objectives to deny the deductibility of a particular type of fine or penalty. The views of the House of Commons Standing Committee on Finance will be sought in respect of any proposals to exercise this regulatory power.

This amendment will apply to fines and penalties imposed after March 22, 2004. The Canada Revenue Agency will continue to review fines and penalties imposed on or before that date, to determine whether they are deductible under the previously-existing law.

Pending the outcome of ongoing work relating to the harmonization of administrative rules—including penalties and interest—under various tax statutes, it is proposed that this prohibition on the deductibility of penalties not apply to penalty interest imposed under the Excise Act, the Air Travellers Security Charge Act and the GST/HST portions of the Excise Tax Act.

Income Trusts

Background

Income trusts have become an increasingly important investment vehicle in Canada. The income trust structure has been used for more than 10 years to manage real estate holdings (real estate investment trusts, or REITs) and to fund the ongoing operation of resource properties (resource royalty trusts). More recently, businesses in other sectors of the economy have begun to use the income trust structure. These are known as business income trusts.

> How Do Income Trusts Work?
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> Income trusts typically raise capital by offering trust units to the public. Using the proceeds from such an offering, income trusts generally invest in assets that provide a return based on the revenues of an active business. This return is often achieved through the acquisition of equity and debt instruments, royalty interests or real properties that are leased back to the operating business.
>
> Net earnings retained within the trust are taxed at the top federal-provincial personal income tax rate. The trust can distribute (flow) its earnings to its unitholders on a before-tax basis. Such distributions are considered to be income in the hands of the unitholders. The extent to which that income is taxed is dependent on the tax status of the unitholder.
>
> Trusts may also distribute amounts that are not taxable. These distributions may be a reimbursement of capital or tax-deferred cash flows generated by the trust from non-cash deductions (such as capital cost allowance) that have been claimed by the trust. These amounts are not subject to tax in the hands of the unitholders, but reduce the adjusted cost base of the units for purposes of determining capital gains or losses on disposition.

The income trust model has provided an additional vehicle for businesses to access capital markets. It has provided additional choice and flexibility for businesses as they determine the most advantageous structure for their particular circumstances, whether that is a public corporation, an income trust, a partnership, or a private corporation. Businesses that put a premium on growth tend to use the corporate structure as this form improves their capacity to finance growth through retained earnings. However, when both corporate and shareholder taxation is considered, the corporate structure may result in higher taxes on distributed earnings, when compared to other business structures. Accordingly, certain mature and stable businesses that are not seeking additional capital have been attracted by the business income trust structure because it improves their ability to distribute earnings.

Governance

It is important for income trusts to have sound governance structures and for investors to be aware of the rights and risks that they assume. For example, shareholders of corporations have limited liability—that is, they are not responsible for the debts or other liabilities of the corporation. It is not clear that the trust structure offers the same limits to the liability of investors as the corporate form. Provinces and provincial securities regulators have key responsibilities in these areas, and in recent months have begun to take action to address emerging issues constructively. This, together with the continuing evolution of the sector, should help to ensure the integrity of the income trust market.

Revenue Impact

Assessing the impact of income trusts on government revenues requires that a broad range of factors be taken into account, including the timing and extent of taxation. For example, the use of income trusts:

- Typically shifts the taxation of income to unitholders; tax revenue foregone at the corporate level may be largely compensated by increased tax revenue at the unitholder level.

- Generally accelerates the incidence of taxation at the unitholder level.

- Can defer the incidence of taxation in circumstances where income trust units are held by deferred income plans such as registered pension plans (RPPs) and registered retirement savings plans (RRSPs).

- Can result in some revenue loss to the extent that income trust units are held by non-residents.

Currently, the impact on tax revenues is estimated to be modest because reduced tax revenues at the corporate level are largely offset by increased tax revenues at the unitholder level. This occurs because, at the present time, most unitholders in income trusts are taxable.

Pension Funds

Most of the larger pension funds have not been active investors in the business income trust market. This has been attributed to concerns about potential liability. However, pension funds may consider becoming more active in this market once the liability issue is clarified in provincial legislation, and this may occur in the near future.

Unlimited participation of pension funds in the business income trust market could have a significant impact on the market and government revenues because of their tax-exempt status and their influence in Canadian capital markets.

Budget 2004 proposes two measures to limit the level of investment that a pension fund can place in business income trusts.

First, it is proposed that restricted investment property holdings of pension funds (RPP trusts, RPP corporations and tax-exempt pension investment corporations) be limited to no more than 1 per cent of the book value of the fund's assets. Excess restricted investment property holdings would be subject to a 1-per-cent per-month penalty tax. For this purpose:

- Restricted investment property would include direct holdings (units and debt) of business income trusts. It would also include holdings of investment vehicles such as mutual fund trusts, which give pension funds indirect exposure to business income trust investments.

- Holdings in an investment vehicle would be restricted investment property if more than 1 per cent of its holdings consist of restricted investment property. This treatment would be similar to the manner in which investment vehicles are generally treated for the purposes of the foreign property limit.

Second, it is proposed that investment by pension funds will be limited to no more than 5 per cent of the units of any business income trust. Excess holdings in any given business income trust would also be subject to a 1-per-cent 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 REITs, given that pension funds can invest directly in the type of property held by those entities. Deferred income plans that are not RPPs, such as RRSPs and registered retirement income funds (RRIFs), will not be affected by these proposals.

Existing investments by pension funds in business income trusts will be given transitional relief. Specifically, existing investments in restricted investment property would not give rise to penalty tax themselves, but they would be taken into account in determining the extent to which new restricted investment property investments could be acquired. This transitional relief for direct holdings in business income trusts would cease after 10 years. Transitional relief for indirect holdings, however, would cease after five years in recognition of the greater risk for pension funds to expand their holdings in income trusts through indirect investments such as pooled investment vehicles and other mutual funds.

To ensure that investment vehicles such as mutual funds have sufficient time to develop systems required to monitor the new limits and possibly restructure their portfolios, it is proposed that these penalty taxes apply for months that end after 2004.

Non-Residents' Investment Through Mutual Funds

In general, non-residents are subject to income tax in Canada in respect of gains arising on the disposition of taxable Canadian property (TCP). The definition of TCP in the Income Tax Act includes real property situated in Canada, shares of the capital stock of private corporations and an interest in a partnership if more than 50 per cent of the value of the partnership's property is attributable to TCP. Canadian resource property and timber resource property are also TCP for certain purposes of the Income Tax Act.

Although Canada's tax treaties limit the extent to which Canada can tax the gains of a resident of a treaty partner country, treaties allow Canada to tax gains on certain core kinds of TCP: in particular, real property situated in Canada and Canadian resource (including timber resource) property. However, under Canada's domestic law, non-residents who invest in Canada through Canadian mutual funds are generally not taxed in Canada on any of the Canadian-source gains they realize on those investments. Nor is the mutual fund itself taxed on the gain: because it has distributed the gain, the fund can deduct it in computing its own income.

To reduce the disparity between the tax treatment of those non-residents who invest in TCP through a Canadian mutual fund and the treatment of those who invest directly, the budget proposes the following measures.

Taxation of TCP Gain Distributions

The distributions that any Canadian mutual fund pays out of its gains on taxable Canadian property will be treated, if the mutual fund is a trust, as Canadian-source trust income or, if the mutual fund is a corporation, as a taxable dividend, subject to the existing non-resident withholding tax (under Part XIII of the Income Tax Act). That tax applies at a statutory rate of 25 per cent, but is typically reduced by tax treaty to 15 per cent.

This measure will apply in respect of distributions of gains realized on dispositions after March 22, 2004.

Withholding on Otherwise Non-Taxable Distributions

An income tax will be applied, as a tax on capital gains, to certain otherwise tax-free distributions made after 2004 by Canadian mutual funds to their non-resident investors. The tax, at a rate of 15 per cent, will be withheld from the distribution at source.

The distributions that will be subject to this new tax are those paid on units or shares of Canadian mutual funds that are listed on a prescribed Canadian or foreign stock exchange, and the value of which is principally attributable to Canadian real estate or Canadian resource property. To the extent that a distribution is already taxable in the hands of the investor as income (including the TCP-based distributions described above), it will not be subject to the withholding.

The new tax withheld on the distribution will be a final tax. The non-resident investor will not need to report the distribution on a Canadian income tax return, nor will the cost base of the share or unit have to be adjusted to reflect the distribution.

Losses on Disposition

In some cases, a non-resident investor may realize a loss on disposing of an investment in an exchange-traded Canadian mutual fund. Since any gain arising on the disposition would not be subject to tax in Canada, the non-resident investor is ordinarily not permitted to use that loss—for example, to offset a gain on some other taxable Canadian property. The introduction of the new tax on distributions, however, makes it appropriate that there be some recognition of these losses.

If a non-resident investor realizes a loss on the disposition of a unit or share in respect of which the investor has paid the new tax on distributions, the investor can file a special Canadian income tax return for the year the unit or share was disposed of. To the extent that the loss does not exceed the total of the distributions taxed in respect of that unit or share, the investor can apply the loss to offset those distributions—or to reduce other distributions, on other shares or units, that have been subject to the new tax on distributions. Where this occurs, a refund of some or all of the tax withheld may be claimed. This special form of capital loss, usable only for this purpose, may be carried back three taxation years or carried forward indefinitely.

Example

Facts

Units of Property Trust (PT), a Canadian real estate investment trust, trade on a prescribed stock exchange. The value of the units is always attributable to real property in Canada.

On January 1, 2005, an investor resident in the US acquires 10,000 units of PT. The investor's total cost base of the units is $100,000, or $10 per unit.

Over the course of 2005, PT makes the following distributions:

- 30 cents per unit as a distribution of PT's income for the year.
- 10 cents per unit as a distribution of gains PT realized in the year on the disposition of Canadian real estate.
- 20 cents per unit as a different, otherwise non-taxable distribution.

On January 2, 2006, the investor sells 5,000 units of PT. The investor's proceeds from the sale are $45,000, or $9 per unit—realizing a $5,000 loss.

Tax effects

In accordance with existing law and the Canada-U.S. tax treaty, Canada applies a 15-per-cent withholding tax to the 30-cent-per-unit income distribution. Under these proposals, the 10-cent-per-unit distribution attributable to gains on Canadian real estate will also be subject to that same tax.

The 20-cent-per-unit distribution will be subject to the new 15-per-cent tax. A distribution tax of $300 ($0.20 X 10,000 units X 15%) will be withheld from the distribution.

Having realized a $5,000 loss in 2006 on the disposition of 5,000 units of PT, the investor can choose to file the special tax return for that year. In that return, the investor can claim $1,000 of that loss against the $1,000 distributed on the sold units. This will entitle the investor to a refund of $150 of the tax collected from the distribution. (The remaining $4,000 loss is not available for carryover since the investor's distributions on the sold units totaled just $1,000.)

Investments by Mutual Funds in Resource Properties

As discussed above, non-residents who invest directly in certain TCP are subject to taxation in Canada in respect of gains arising on the disposition of that property. If such property is held in a mutual fund in which non-residents hold units or shares, however, gains resulting from the disposition of such property can be distributed to non-resident investors at reduced levels of Canadian tax. In some cases, the gains may be distributed tax-free.

Special rules were introduced to the Income Tax Act in 1990 to restrict the use of mutual fund trusts and mutual fund corporations (mutual funds) as intermediaries through which non-residents may invest in TCP without being subject to an appropriate level of Canadian tax. In general terms, if more than 10 per cent of the mutual fund's property consists at any time of TCP and the mutual fund is established or maintained primarily for the benefit of non-residents, the fund may lose its status as a mutual fund.

The use of mutual funds to reduce Canadian tax has particular relevance to investments in Canadian real property, Canadian resource property and timber resource properties, since non-resident persons generally do not benefit from any tax treaty relief with respect to gains from such property (i.e. such properties are not treaty-protected properties).

The budget therefore proposes to clarify, for the purpose of the special rules limiting non-resident participation in mutual funds, that the properties a mutual fund must include in computing its 10-per-cent threshold will include Canadian resource properties and timber resource properties. A mutual fund that was on March 22, 2004, a mutual fund trust or corporation and that would otherwise cease, on March 23, 2004, to qualify as a mutual fund trust or corporation because of this proposal will have until January 1, 2007, to comply with the modified rule. This is intended to accommodate mutual funds and their investors in providing an orderly transition to comply with this clarification.

Improved Information Reporting

To improve the ability of trust beneficiaries to comply with the income tax law, trusts will be required to provide to their beneficiaries further information on the composition of distributions received from the trust. Trusts will be required to identify what portion, if any, of a distribution will give rise to an adjustment in the cost base of the beneficiary's interest in the trust. This measure will apply starting for information slips issued in respect of distributions made in respect of a trust's 2004 taxation year. Generally, these slips are required to be issued by a trust within 90 days after the end of its taxation year.

Monitoring

The Department of Finance will continue to evaluate the development of the income trust market as part of its ongoing monitoring and assessment of Canadian financial markets and the Canadian tax system.

General Anti-Avoidance Rule

A statutory general anti-avoidance rule was introduced in the Income Tax Act in 1988. This rule is intended to prevent abusive or artificial tax avoidance schemes, without interfering with legitimate commercial and family transactions. In seeking to distinguish between legitimate tax planning and abusive tax avoidance, the general anti-avoidance rule aims to establish a reasonable balance between the protection of the tax base and the need for certainty for taxpayers in planning their affairs.

Budget 2004 proposes to clarify that the Act's general anti-avoidance rule applies to a misuse or abuse of the provisions of the Income Tax Regulations, the Income Tax Application Rules (ITARs), and any enactments amending the Act, Regulations or ITARs, as well as to a misuse or abuse of a tax treaty.

Affiliated Persons Rules and Trusts

For many purposes under the Income Tax Act, it is necessary to identify persons who have economic interests in common. For example, a person is not permitted to realize a tax loss upon transferring a property to a corporation the person controls: since the person indirectly retains an economic interest in the property, any tax recognition for such losses would be premature.

The Act includes several sets of rules that establish the circumstances in which persons are considered to share economic interests. These include rules on related persons, associated corporations, connected corporations and affiliated persons—the last of which is the standard that applies in respect of losses.

The existing affiliated persons rules do not deal comprehensively with trusts, and this can produce results at odds with the underlying intent of the rules that affect loss realizations. On the one hand, losses on true economic dispositions of property involving trusts are in some cases denied. For example, a trust having as its trustee a commercial trust company, and a brokerage firm controlled by the same financial institution that controls the commercial trust company, might be affiliated under the existing rules, even if the trust has no other connection to the group. As a result, tax recognition of losses arising from a sale of shares by the trust to the brokerage would be deferred.

On the other hand, losses may be claimed on dispositions where use of a trust allows a taxpayer to retain an economic interest in the transferred property. For example, a taxpayer might be able to claim a loss under the present regime on a transfer of property to a trust of which he or she is the sole beneficiary (but not the trustee).

These results are inappropriate and inconsistent with how the rules apply to dispositions involving corporations and, particularly, partnerships.

The budget proposes to expand, for the purposes of the Act, the scope of the affiliated persons rules to deal more fully with trusts. This will be done in a manner that is generally consistent with how the rules apply to partnerships. Not only will this ensure that the loss deferral rules apply as intended to property dispositions involving trusts, but it will also improve the application of other rules that use the affiliation standard, such as those concerning non-resident persons who receive investment advice from Canadian service providers.

Budget 2004 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 income or capital, and generally also with any person affiliated with such a beneficiary. After March 22, 2004, two trusts will be affiliated if two conditions are met:

- A person who has contributed property to one of the trusts on a non-arm's length basis or for inadequate consideration is affiliated with any such person in respect of the other trust.
- Beneficiaries that enjoy a majority of the income or capital of the trusts are affiliated.

In the case of a discretionary trust, these new rules will apply as if any discretion of any person in respect of the trust had been fully exercised (or not exercised, as the case may be) in respect of each person who is a potential beneficiary of the discretion.

Patronage Dividends

Co-operatives and many credit unions regularly distribute earnings to their members or customers in the form of patronage dividends—amounts computed at a rate in proportion to the amount of business done with the member or customer. The Income Tax Act allows a corporation or other person that pays patronage dividends to deduct the payments in computing income. Patronage dividends received by a customer or member, with the exception of those with respect to certain consumer goods or services, are included in computing the recipient's income. Ordinary taxable dividends, on the other hand, are not deductible by the payor corporation.

Under certain circumstances, the current system could allow entities that are neither co-operatives nor credit unions to use patronage dividends in ways that erode the Canadian tax base. For example, a patronage dividend could be paid by a wholly-owned Canadian subsidiary to its U.S. parent company, with the intended result that all of the subsidiary's tax liability is eliminated, and the only tax applicable is non-resident withholding tax.

While the general anti-avoidance rule may address some of these cases, the budget proposes to amend the Income Tax Act to prevent persons, other than co-operatives and credit unions, from deducting patronage dividends paid after March 22, 2004, to non-arm's length persons. This amendment will prevent unintended application of the patronage dividend provisions.

Taxpayer-Requested Adjustments

In 1991 the Income Tax Act was amended to allow an individual or testamentary trust to request that the Minister of National Revenue accept a late-filed return for a taxation year, or reassess an income tax return beyond the normal reassessment period for a taxation year (generally 3 years), in order to provide for an income tax refund. This measure allowed the Minister to assess or reassess returns for the 1985 and subsequent taxation years. At the same time, the Act was also amended to permit the Minister of National Revenue to accept late-filed, amended, or revoked elections for taxation years after 1984 where an intention to make (or revoke) the election can be shown, and to waive or cancel penalties or interest for taxation years after 1984 in situations where factors beyond the taxpayer's control, such as illness or a natural disaster, prevented a tax return from being filed on time. However, these provisions did not include a mechanism to update the 1985 base year.

Administrative problems can arise in verifying claims made for taxation years going as far back as 1985. The budget therefore proposes that, for applications for relief made after 2004, adjustments made under these provisions be limited to taxation years that end in any of the ten preceding calendar years.

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.

Trading Charitable Donations

Individuals who make charitable donations, but who do not have sufficient tax payable in the year of donation to use all of the resulting tax credits, may carry forward their unused credit balance to be claimed in any of the five subsequent taxation years. Similarly, corporations may carry forward unused charitable donations deductions for up to five taxation years. There are no provisions in the Income Tax Act intended to allow individuals or corporations to sell or otherwise transfer these unused claims to other taxpayers, except in certain circumstances where a corporation is wound up into its parent corporation or amalgamates with another corporation to form a new successor corporation.

In recent years, however, transactions have occurred under which a donation of property is made indirectly, by a person who could not otherwise use the resulting charitable donations deductions or credits, by means of a transfer of the property to a corporation, the subsequent donation of the property by the corporation to a charity, followed by a sale of the shares of the corporation to another corporation that is in a position to make use of the unused charitable donations deductions.

In this regard, and in response to similar transactions involving other deductions, the Income Tax Act includes provisions that restrict the deductibility of accumulated losses and other tax pools after control of the corporation is acquired. In particular, capital losses realized by a corporation before an acquisition of control of the corporation cannot be carried forward for deduction after the acquisition of control.

The budget, therefore, proposes that the Income Tax Act be amended to provide that charitable donations deductions of a corporation that were unused at the time control of the corporation was acquired will be claimable only for taxation years that end before that acquisition of control. This restriction will treat unused charitable donations deductions of a corporation in a manner that is similar to the treatment accorded capital losses and will ensure that unused charitable donations deductions cannot be traded.

To prevent avoidance of this rule, it is proposed that no charitable donations deduction be allowed in respect of a gift of a property by a corporation (or a successor corporation) after the time control of the corporation has been acquired, if the property was acquired by the corporation before that time under an arrangement under which it was expected that control of the corporation would be so acquired and the gift would be so made.

These amendments will apply in respect of gifts made after March 22, 2004.

Notices Served on a Financial Institution

The Bank Act, the Trust and Loan Companies Act and the Cooperative Credit Associations Act (CCAA) require that, for notices and orders with respect to a customer of any Canadian bank, foreign bank branch, trust or loan company or an association governed by the CCAA (all of which are referred to here as a bank) to be binding on the bank, the notices or orders must be served at the branch of the bank that is the branch of account of the customer or the branch where the property of the customer is held. An exception to this requirement applies for enforcement notices with respect to family financial support. These notices can be served at a designated office of a bank.

The requirement to serve notices and orders at a particular branch gives rise to difficulties in the enforcement of the tax laws. The Canada Revenue Agency (CRA) may, for example, know that a taxpayer has an account with a given bank, but not know which particular branch is the branch of account.

To facilitate the efficient administration of the tax system, the Bank Act, the Trust and Loan Companies Act and the CCAA will be amended to provide that the CRA may serve notices or orders under the laws it administers at either the branch of the bank that is the branch of account of a customer or at a designated office of the bank.

It is expected that, to comply with this amendment, each bank will use the offices designated for enforcement notices for family financial support, although a bank would be able to designate different offices for the purposes of CRA notices and orders.

The notices or orders served in accordance with this amendment would fix the bank with knowledge of its content and the action required, and, where applicable, would be binding on property of the customer in the possession of the bank.

This measure will take effect on Royal Assent.

Registered Charities—Regulatory Reforms

There are approximately 80,000 charities registered under the Income Tax Act. Canadians recognize the value of charitable giving and the important contribution that Canada's registered charities make towards improving quality of life. In 2002 alone, 5.5 million Canadians made financial or in-kind donations worth $5.8 billion.

In March 2003 the Joint Regulatory Table (JRT), in its report "Strengthening Canada's Charitable Sector: Regulatory Reform", made 75 recommendations for improvements to the rules governing charities under the Income Tax Act. This report is the result of extensive consultations between the Government of Canada, the charitable sector and other key stakeholders. The JRT was launched in November 2000, as one of six tables established by the Government's Voluntary Sector Initiative.

Registered charities have not benefited from any significant updating to the administrative regime since 1983. The following budget measures significantly improve the regulatory framework for registered charities. These measures will also enhance Canadians' confidence that their generous donations to registered charities are well-managed. Specifically, Budget 2004:

- Responds to the recommendations of the JRT concerning registered charities by proposing:
  - A new compliance regime.
  - A more accessible appeals regime.
  - More transparency and greater accessibility to information.
- Proposes to improve the disbursement quota rules.

Compliance Regime

Overall Compliance Strategy

The JRT established as key principles of regulatory reform that the regulatory framework should uphold the integrity of the provisions in the Income Tax Act and facilitate public trust in the work of charities.

Currently, the only sanction against a registered charity that does not comply with the requirements of the Income Tax Act is the revocation of its status as a registered charity (i.e. de-registration). A revoked charity loses its tax-exempt status and its privilege to issue tax receipts. It must also transfer its assets within one year from its revocation to one or more registered charities. Any property remaining in the hands of the charity one year after the revocation must be transferred to the Crown. This requirement is often referred to as the revocation tax.

Each year the registration of about 2,000 charities is revoked. Most of those revocations occur because of a failure to file the required annual information return, or because the charity is being discontinued. A small number (15-20) are revoked each year for serious non-compliance.

Because of its harshness, revocation is seldom imposed for minor infractions. Consequently, lesser forms of non-compliance may go unchecked, thus diminishing public confidence in the legitimacy of charities and in how donations are spent.

Budget 2004 therefore proposes a more responsive approach to the regulation of charities for Income Tax Act purposes, taking into account the small size of most registered charities and the goodwill of the volunteers who operate them.

The first priority will be to encourage compliance through education. The Canada Revenue Agency (CRA) will work in partnership with leading sector organizations to help volunteers and employees who work for charities to know and understand the rules better.

Coupled with the continued use by the Minister of National Revenue of compliance agreements to help correct minor or inadvertent infractions, this new approach will emphasize risk control, problem solving, and compliance management. The Minister of National Revenue will continue to be able to revoke the registration of charities for more severe cases of non-compliance.

In addition, the budget proposes to introduce new, more effective sanctions that are more appropriate than revocation for relatively minor breaches of the Income Tax Act. The proposed sanctions will generally respond directly to activities that contravene the rules, thereby making the income tax rules for charities clearer and fairer. The sanctions will also be progressive, generally increasing in severity for repeat infractions. All proposed sanctions deal with infractions that are already identified in the Act. Moreover, a mechanism will be established to allow financial penalties to be reinvested in the charitable sector.

Proposed Intermediate Taxes and Penalties

Proposed sanctions and taxes include:

- The taxation of gross revenue generated by a registered charity from prohibited activities that generate income. The tax will apply: to private foundations that carry on a business activity; to charitable organizations and public foundations that carry on an unrelated business activity; and to foundations that acquire control of a corporation through means other than those allowed under the Act.

- Suspension of a registered charity's tax-receipting privileges for using donated funds other than for charitable purposes. This may include, for example, situations where a registered charity provides undue benefits to its trustees. A suspended charity will be prohibited from issuing official receipts and from receiving funds from qualified donees—that is, other organizations that can also issue official receipts—for a period of one year. The charity will also be required to advise potential donors of its suspension. A suspended charity's administrative and regulatory obligations—for instance, meeting its disbursement quota, or filing its annual information return—will continue during the suspension period.

- Monetary penalties for failure by a registered charity to file its annual information return on time as stipulated in the Act, together with publication of the names of late- or non-filers. These measures are intended to encourage registered charities to be more diligent in filing annual information returns for the benefit of the public and the tax authorities. Registered charities currently have six months from the end of their fiscal year to file an annual information return. Registered charities that have not filed on time will, as a first step, be subject to a penalty of $500. Further, registered charities that do not file upon the receipt of a demand to file from the Minister of National Revenue will have their registration revoked. Revoked charities will be allowed to apply for re-registration. If they do so apply and are re-registered within one year of the date of revocation, they will not be required to pay the revocation tax, provided they file the missing returns, pay all outstanding penalties and other taxes, and otherwise comply with the provisions of the Income Tax Act. However, revoked charities that are not re-registered during that period will be subject to the revocation tax.

The proposed new sanctions regime is described in more detail in the table below. Charities will have the right to object to the imposition of an intermediate tax or penalty and, subsequently, to appeal to the Tax Court of Canada.

Table A9.3
Registered Charities: Intermediate Taxes and Penalties

	Tax or Penalty (Unless registration of the charity is revoked)	
		Repeat infraction (Repeated acts or omissions will increase the probability of

Infraction	First infraction	revocation)
Late filing of annual information return	$500 penalty	$500 penalty
Issuing of receipts with incomplete information	5% penalty on the eligible amount stated on the receipt	10% penalty on the eligible amount stated on the receipt
Failure to comply with certain verification and enforcement sections of the Income. Tax Act (230 to 2315), eg keeping proper books and records	Suspension of tax-receipting privileges	Suspension of tax-receipting privileges
Charitable organization or public foundation carrying on an unrelated business	5% tax on gross unrelated business revenue earned in a taxation year	100% tax on gross unrelated business revenue earned in a taxation year and suspension of tax-receipting privileges
Private foundation carrying on any business	5% tax on gross business revenue earned in a taxation year	100% tax on gross business revenue earned in a taxation year, and suspension of tax-receipting privileges
Foundation acquires control of a corporation	5% tax on dividends paid to the charity by the corporation	100% tax on dividends paid to the charity by the corporation
Undue personal benefit provided by a charity to any person. For example, a transfer to a person who does not deal at arm's length with the charity or who is the beneficiary of a transfer because of a special relationship with a donor or a charity	105% tax on the amount of undue benefit	110% tax on the amount of undue benefit and suspension of tax-receipting privileges
A gift that is restricted under subsections 149.1(2), (3) or (4) of the Act	105% tax on the amount of the gift	110% tax on the amount of the gift
Issuing receipts in a taxation year for eligible amounts that in total do not exceed $20,000 if there is no gift or if the receipt contains false information	125% tax on the eligible amount stated on the receipt	125% tax on the eligible amount stated on the receipt
Issuing receipts in a taxation year for eligible amounts that in total exceed $20,000, if there is no gift or if the receipt or if the receipt contains false information	Suspension of tax-receipting privileges and 125% tax on the eligible amount stated on the receipt	Suspension of tax-receipting privileges and 125% tax on the eligible amount stated on the receipt
Delaying expenditure of amounts on charitable activities through the transfer of funds to another registered charity	The charities involved are jointly and severally, or solidarily, liable for the amounts so transferred plus a 10% tax on those amounts	The charities involved are jointly and severally, or solidarily, liable for the amounts so transferred plus a 10% tax on those amounts

Notes:

These intermediate sanctions will not prevent application of the current provisions, which allow the Minister of National Revenue to revoke the registration of a charity in respect of any of the above infractions. For example, failure to file an information return may result in revocation of registered status upon a first infraction.

This chart does not include infractions for which no tax or penalty would be assessed, yet which would lead to revocation, e.g. ceasing to conduct charitable activities.

Taxes and penalties will be assessed in aggregate for a taxation year.

A repeat infraction is an action in a taxation year that gives rise to a tax or penalty in respect of which an assessment was previously raised for a preceding taxation year.

Rules of general application may also apply in addition to the sanctions referred to above, e.g. the failure to keep proper books and records is an offence punishable by a fine or imprisonment.

These measures will apply in respect of taxation years that begin after March 22, 2004.

Transfer of Amounts in Respect of Taxes and Penalties

Where a particular charity is required to pay taxes and penalties for a taxation year which total more than $1,000, the charity will be permitted to satisfy its liability by transferring amounts to eligible donees as determined by the Minister of National Revenue. This will ensure that funds raised for charity may continue to be applied to charitable purposes.

For these purposes, an eligible donee in respect of a particular charity is a registered charity that satisfies all of the following conditions:

- It is fully compliant with the requirements of the Income Tax Act (i.e. not at that time subject to any tax, penalties or suspensions, etc. under the Act).
- It is not subject to a certificate pursuant to the Charities Registration (Security Information) Act.
- It is a charity, more than 50 per cent of the members of the board of directors or trustees of which deal at arms' length with each member of the board of directors or trustees of the particular charity.

Revocation

The Minister of National Revenue will retain the authority to revoke the registered status of a charity for severe breaches of the Income Tax Act including continued, repeated or cumulative infractions, and in cases where it is clear that the organization is being operated for purposes that are not charitable.

In addition, Budget 2004 proposes to allow the Minister of National Revenue to revoke the registration of an organization that obtained its registration on the basis of false or deliberately misleading information. This new ground for revocation is intended to provide the Minister of National Revenue with an expedited method of dealing with organizations that have obtained registration on false pretences.

Revocation Tax

Currently, a charity that has had its registration revoked has one year from the date of that revocation to divest itself of its assets—to registered charities or other qualified donees. The balance of the net assets of a revoked charity, after this divestiture, must be transferred to the Crown as a revocation tax.

Eligible Transfers on Revocation

The budget proposes that a particular charity whose registration has been revoked will be able to transfer assets only to registered charities, and only where those charities satisfy the conditions of the new eligible donee definition set out above. Other qualified donees such as municipalities, foreign universities and United Nations Agencies will not be eligible for transfers on divestiture, since the intent is to keep the money invested within the charitable sector in Canada, and applied to charitable purposes that are analogous to those for which the funds were originally raised.

Freezing Tax-Assisted Assets

The ability of a revoked charity to divest assets within one year of revocation provides a one-year suspension of any collection action in respect of the revocation tax. Cases can arise, however, where the Minister of National Revenue becomes aware that a revoked charity's assets are being diverted or directed for private benefit.

In order to collect the revocation tax in a timely manner, the budget proposes that the revocation tax be assessed in the Notice of Intended Revocation issued by the Minister of National Revenue. The assessment will be based on information received as a result of an audit or from the latest information return submitted by the charity. The normal suspension of collection for one year from the date of the publication of the Notice will not apply if the CRA obtains authorization from a judge to commence collection proceedings before that time. A charity whose registration has been revoked will retain the opportunity to satisfy the liability by transferring assets to an eligible donee, as described above.

Annulment

The Income Tax Act will be amended to provide explicit authority to the Minister of National Revenue to annul an organization's registration in circumstances where the Minister registered the organization in error. In recognition of the CRA's role in registering charities, and consistent with the current practice of the Minister of National Revenue under annulments made pursuant to administrative law, a revocation tax will not be applied in such circumstances, and official receipts issued prior to annulment will be honoured.

The measures relating to revocation and annulment will apply to notices issued by the Minister of National Revenue after the later of December 31, 2004 and 30 days after Royal Assent to any measure giving effect to this proposal.

Appeals Regime

Where a registered charity or applicant for registration disagrees with a decision of the Canada Revenue Agency (CRA), its recourse is to appeal the decision to the Federal Court of Appeal. Budget 2004 proposes to make the appeals process more accessible and affordable for registered charities and unsuccessful applicants by creating an impartial CRA internal reconsideration process for matters affecting charities, and by allowing for appeals of taxes and intermediate penalties to be made to the Tax Court of Canada.

Internal Reconsideration Process

Unlike other taxpayers, registered charities and applicants do not currently have access to the internal objection review process of the CRA. The budget proposes to extend the application of CRA's existing objection review process to notices of decisions regarding:

- Applications for registration that have been denied.
- Revocations or annulments of a charity's registration
- Designations relating to whether a registered charity is a private or public foundation or one that is directly involved with charitable programs and services.
- Impositions of any taxes or penalties against a registered charity.

As part of this objection process:

- A valid Notice of Objection by an organization will be required to be filed within 90 days from the issuance by the CRA of the notice which is the subject of the objection.
- The results of the review will be required to be communicated to the organization in writing.
- The objection process will be mandatory before an appeal may be made to a court.

External Appeals Process

Appeals of decisions on registration and revocation will continue to be directed to the Federal Court of Appeal. Appeals of decisions to annul the registration of a charity will also be directed to the Federal Court of Appeal. Appeals of taxes and penalties, described above under the heading *A New Compliance Regime for Registered Charities,* may be directed to the Tax Court of Canada.

It is proposed that these measures apply in respect of notices of decisions referred to above that are issued by the Minister of National Revenue after the later of December 31, 2004, and 30 days after Royal Assent to any measure giving effect to this proposal.

This new objection and appeals processes will not apply to an applicant or a registered charity that is the subject of a certificate under the Charities Registration (Security Information) Act. The current process for such cases will continue to apply.

Transparency and Accessibility of Information

The Canada Revenue Agency (CRA) is authorized to disclose information about the status of registered charities and some of their financial information.

The budget proposes to further enhance transparency and accessibility by making new information available on registered charities, the registration process, regulatory decisions, and compliance activities and results. These proposals will not compromise existing safeguards that are in place to protect the privacy of individuals.

Making the CRA's decision process more transparent and accessible will enhance the charitable sector's awareness of the income tax rules and how they are applied. At the same time, greater transparency and accessibility means greater accountability, serving to reinforce confidence within the donating public in the integrity of the CRA and the charitable sector.

Information Pertaining to Registered Charities

At present, Canadians have access to a variety of useful information on currently or previously registered charities. This includes annual information returns, governing documents, the names of directors and the periods during which they were directors, registration letters and notices of revocation.

Budget 2004 proposes to authorize the Minister of National Revenue to release to the public the following additional information regarding registered charities, where such information has been submitted to the Minister after 2004:

- Financial statements that are filed with annual information returns.
- Letters sent by the CRA to a charity relating to the grounds for annulment of the charity's registration.
- The CRA's decisions regarding a notice of objection filed by a registered charity.
- The information that a registered charity has filed in support of an application for special status or an exemption under the Act, as well as any responses to such applications from the CRA (e.g. requests for permission to accumulate assets).
- The identification of a registered charity on which a sanction has been imposed, the type of sanction imposed, and the letter sent to the charity relating to the grounds for the sanction.

Information Pertaining to Organizations Denied Registration

Currently, no information is made available to the public about organizations that have been denied registration as registered charities under the Income Tax Act. Access to such information will assist the charitable sector and the public in understanding how the CRA determines whether an organization meets the criteria for registration as a registered charity. Accordingly, the CRA will make available its reasons for denying the registration of an organization. This will include, in such a manner as to withhold the identity of an applicant, the following information if submitted or received by an organization in the course of making an application to the CRA for registration as a registered charity:

- The governing documents of the organization, including the organization's statement of purpose.
- Information disclosed by the organization in the course of making the application.

- A copy of the notice of denial in respect of the organization.

- A copy of the decision, if any, of the CRA's Appeals Branch regarding a notice of objection, if any, filed by the organization.

Additional Information on Official Tax Receipts

The Income Tax Regulations currently require registered charities to include certain information on their official receipts, such as details about the charity and the donor, the eligible amount in respect of the gift and the date of the gift. The budget proposes to also require that the name and website address of the CRA appear on all official receipts. This change will take effect for receipts issued after 2004.

Increasing Public Information and Sector Education

The CRA proposes to increase public education on what to be aware of when giving to charities, how to confirm the status of a charity, and how to file a complaint about a charity. In addition, the CRA will post on its website the reasons for its registration decisions as well as the policies, procedures and research databases it uses for its decision-making. The CRA will also make available to the public an annual report on its activities related to registered charities.

A More Transparent Relationship with the Charitable Sector

Registered charities will now have a stronger voice in shaping the administration of tax rules through a newly created Charities Advisory Committee. The Committee will be comprised of sector representatives, and mandated to advise the Minister of National Revenue on these administrative issues.

Disbursement Quota Rules

In order to retain registered status, charities must fulfil minimum annual disbursement requirements set out in the Income Tax Act. These rules, known as the disbursement quota rules, ensure that a significant portion of a registered charity's resources are devoted to charitable programs and services, rather than, for example, fundraising, management, or administration. A summary description of these rules is provided below.

Overview of Current Disbursement Quota Rules

A registered charity must annually disburse an amount at least equal to the total of the following:

- 80 per cent of tax-receipted donations (other than endowments) received by it in the previous year.

- 80 per cent of the proceeds from the disposition of endowments in the year.

- For charitable foundations, 4.5 per cent of the fair market value of its capital assets (such as investments) that are not used directly in charitable activities or administration.

- For charitable foundations, a percentage of amounts received by it from other registered charities: 80 per cent for public foundations and 100 per cent for private foundations.

A registered charity meets its annual disbursement obligation by expending amounts on the delivery of its own charitable programs and services, or by transferring funds to registered charities and other qualified donees.

The budget proposes to introduce several changes to the disbursement quota rules and to eliminate certain regulatory barriers to ensure that registered charities can effectively manage the gifts entrusted to them by Canadians.

Disbursement Quota on Capital Assets

Disbursement Quota Rate

Budget 2004 proposes to replace the fixed 4.5 per cent disbursement quota rate with a new rate that is more representative of historical long-term real rates of return earned on the typical investment portfolio held by a registered charity.

Given the ongoing nature of charitable activities, it is appropriate to allow charities to maintain a capital asset base on a sustainable long-term basis. Accordingly, the disbursement quota rate on capital assets should be set at a level that can sustain the real value of a charity's capital assets over the long-term. This is consistent with the long-term intentions of donors who provide gifts in the form of endowments.

Analysis indicates that the current 4.5-per-cent disbursement quota rate is high relative to long-term investment returns. Accordingly, the budget proposes to reduce the 4.5-per-cent disbursement quota rate on capital assets to 3.5 per cent. This rate will be reviewed periodically to ensure that it continues to be representative of long-term rates of return.

This change will apply to taxation years that begin after March 22, 2004.

Realizing Capital Gains from Endowments

Registered charities typically hold capital endowments that produce investment income in the form of capital gains, dividends, and interest. Since an annual disbursement quota is applied on the value of these capital endowments, registered charities will need to use the investment income in order to meet their disbursement obligations. In some cases, the return on an investment is weighted heavily in favour of capital gains, rather than cash flow such as dividends or interest. In these circumstances, a registered charity might prefer to meet its disbursement quota by realizing, and expending, capital gains that have accrued on endowments, if the terms of the gift do not restrict the charity from this action. However, if the charity does so, under the current rules it must then meet an 80 per cent disbursement obligation to the extent that the proceeds of disposition are expended by the charity. The effect of the current rules is to discourage registered charities from realizing capital gains in order to meet disbursement obligations to fund charitable programs and services.

Budget 2004 therefore proposes to reduce the 80 per cent disbursement requirement that applies to the expenditure of proceeds from the disposition of such endowments, by the lesser of 80 per cent of the capital gain realized on the disposition and 3.5 per cent of the value of all property not used directly in charitable activities or administration.

This proposal will apply to taxation years that begin after March 22, 2004.

Extending the 3.5 per cent Disbursement Quota to Charitable Organizations

Historically, charitable foundations were the primary beneficiaries of endowments. For that reason, only charitable foundations were made subject to a disbursement obligation on endowments. Currently, however, both charitable organizations and charitable foundations may hold capital endowments from which they generate investment income. Accordingly, the budget proposes that charitable organizations be made subject to the 3.5 per cent disbursement obligation on their capital assets. With this change, all registered charities will be subject to the same disbursement obligations on their capital assets.

In order to provide charitable organizations registered before March 23, 2004 with sufficient time to adjust to this new requirement, this measure will apply only to their taxation years that begin after 2008. For charitable organizations registered after March 22, 2004, this measure will apply to taxation years that begin after that date.

Transfers Between Registered Charities

Gifts Transferred to Charitable Organizations

Currently, both charitable organizations and charitable foundations may receive funds transferred from other charities. Those transfers may be used to satisfy the disbursement quota of the transferor charity and, if the transfer is made to a registered charitable foundation, is taken into account in calculating its disbursement quota (at a rate of 80 per cent for public foundations and 100 per cent for private foundations). However, the receipt of these transfers is not taken into account in calculating the disbursement quota of a charitable organization.

The budget, therefore, proposes to ensure that all transfers from one registered charity to another are subject to a disbursement requirement. In particular, an 80 per cent disbursement requirement will be applied to transfers (other than specified gifts and transfers of capital endowments, as described below) received by registered charitable organizations in taxation years that begin after March 22, 2004.

Transfer of Endowments

Registered charities often receive gifts by way of bequest or inheritance, or that are subject to a condition that the gift be held by the charity for a period of not less than 10 years. Such gifts are often referred to as endowments.

Where the terms of the endowment so allow, a registered charity may transfer property received as an endowment to another registered charity. However, the existing income tax rules for endowments provide impediments to such transfers, generally because of the interaction of the disbursement obligations on both the transferor and the transferee.

In order to facilitate these transfers, Budget 2004 proposes that an endowment received by a registered charity from another registered charity result in the same treatment as if the endowment had been received directly from the original donor. This will be effected by applying a 100 per cent disbursement requirement to the transferor (which will be satisfied by the transfer), and by treating the endowment in the hands of the recipient charity as if it had been received directly from the original donor.

This proposal will apply to taxation years that begin after March 22, 2004.

Gifts Made by Way of Direct Designation

Currently, upon the death of an individual, a charitable donations tax credit may be claimed in the individual's terminal income tax return for gifts made to a registered charity as a result of a designation of the charity as the direct beneficiary of the individual's registered retirement savings plan (RRSP), registered retirement income fund (RRIF), or life insurance policy. The charitable sector has expressed concern that, while these gifts are analogous to endowments, they are currently subject to the same disbursement quota rules as ordinary gifts.

The budget proposes to treat such gifts made by way of direct designation as endowments for the purpose of the disbursement quota rules. This means that such gifts will be subject only to the 3.5-per-cent disbursement quota while they are held as capital, and the 80-per-cent disbursement requirement in the year they are liquidated.

This proposal will apply to taxation years that begin after March 22, 2004.

Endowments Received and Spent in the Same Year

Currently, endowments are subject to an 80-per-cent disbursement requirement to the extent that the registered charity liquidates and spends the capital in a year following the year in which the gift is received. Budget 2004 proposes that the 80-per-cent disbursement requirement also apply to gifts of capital that are liquidated in the same year that they are received.

This proposal will apply to taxation years that begin after March 22, 2004.

Tax Relief for Canadian Forces Personnel and Police Deployed to International High-Risk Operational Missions

Canada plays an important role in promoting and facilitating peace and stability around the world. This role is fulfilled by relying on the contributions of men and women of the Canadian Forces and Canadian police services (including the RCMP).

Currently men and women serving with the Canadian Forces on high-risk international missions receive special non-taxable allowances, in addition to their regular pay, but the full amount of their regular pay is subject to income tax.

In recognition of the contribution of these individuals, the Budget proposes to exclude from income subject to tax employment income that they earn while serving on high-risk military or police missions outside Canada.

A member of the Canadian Forces or a Canadian police force serving on a deployed operational mission that is assessed for risk allowance pay at level three or higher (as determined by the Department of National Defence) will be entitled to deduct from taxable income the amount of employment earnings from that mission.

Eligible individuals will be entitled to deduct from their taxable income the amount of their related employment earnings from the mission to the extent that those earnings have been included in computing income,
up to the maximum rate of pay earned by a non-commissioned member of the Canadian Forces (i.e. approximately $6000 per month).

Example

Corporal Smith earns a monthly base amount of $3,989 working in Ottawa. If she is posted to operations in Afghanistan, she will earn a foreign service premium, as well as hardship and risk allowances (all of which are non-taxable), amounting to $1,763 per month, for a total compensation of $5,752 per month.

Under the new measure, if Corporal Smith were to be posted in Afghanistan for six months, she would be allowed to deduct in computing her taxable income $3,989 for each of those months. This would provide a total deduction of $23,934, saving her about $4,600 in federal income tax.

This measure will apply to the 2004 and subsequent taxation years.

GST/HST Rebate for Municipalities

As announced in the Speech from the Throne, the Government proposes that the rebate in respect of the goods and services tax (GST) and the federal portion of the harmonized sales tax (HST) for municipalities be increased to 100 per cent from 57.14 per cent. Further, as announced by the Prime Minister in his reply to the Speech from the Throne on February 3, 2004, municipalities are eligible for the increased 100-per-cent rebate effective February 1, 2004.

On March 9, 2004, the government announced further details on the measure and its operation, including proposed consequential amendments required to facilitate an orderly transition to the full rebate, to protect the integrity of the tax system, and to enhance transparency. In particular, these consequential amendments ensure that the 100-per-cent rebate is targeted appropriately to municipalities and that only acquisitions made on or after February 1, 2004, are eligible for the increased rebate. These amendments also include coming-into-force dates and transitional provisions that ensure that the tax results are fair.

A detailed Notice of Ways and Means Motion to implement the proposed increase in the municipal rebate, as well as the necessary consequential amendments, is tabled with the budget.

Other Measures

Education

The budget builds upon existing assistance for education savings provided through registered education savings plans (RESPs) and the Canada Education Savings Grant (CESG). Two measures are proposed to assist education savings for low- and middle-income families:

- The creation of a new Canada Learning Bond for children in low-income families.
- An enhanced Canada Education Savings Grant for low- and middle-income families.

Existing Education Saving Assistance Through RESPs and the CESG

- Contributions to an RESP are not deductible for income tax purposes and they are not taxed upon withdrawal. For each beneficiary of an RESP, there is an annual $4,000 limit and a lifetime limit of $42,000 on contributions.
- Since 1998 the Government has provided a 20 per cent CESG on the first $2,000 of annual contributions (up to and including the calendar year in which the beneficiary turns 17 years of age) made to an RESP, or on contributions up to $4,000 if there is unused grant room from prior years. There is a maximum annual CESG of $400 per beneficiary ($800 if there is unused grant room) and a lifetime limit of $7,200.
- The CESG and the investment earnings in the RESP are available to the beneficiary as Educational Assistance Payments upon enrolment on a full-time basis in a qualifying post-secondary program at a recognized institution.
- Educational Assistance Payments are taxable in the hands of the student in the year they are received. In most cases, the student's relatively low income results in little or no tax.
- If the beneficiary does not pursue post-secondary education, the CESG is returned to the government. The subscriber may generally transfer the investment income in the RESP to his or her registered retirement savings plan (RRSP), if RRSP contribution room is available. Otherwise, the investment income may be paid to the subscriber and included in the subscriber's income. This amount is also subject to a 20 per cent additional tax.
- An RESP must be terminated by the end of the year that includes the 25th anniversary of the opening of the plan.

Canada Learning Bond

Budget 2004 proposes to introduce, effective January 1, 2004, a new Canada Learning Bond (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, up to and including the year in which the child turns 15 years of age.

- An initial CLB of $500 will be provided for the first year of entitlement for the NCB supplement which could be any year from the year of birth up to and including the year in which the child turns 15 years of age.
- Any subsequent CLB will be in the amount of $100, and will be provided in respect of a child for each year in which the family is entitled to the NCB supplement up to and including the year in which the child turns 15 years of age.

A child in a low income family can receive CLB payments totalling up to $2,000, which—with a 3.5 per cent real rate of return—could be worth up to $3,000 by age 18.

Illustrative Examples

Mathieu is born in 2004 and is entitled to a $500 CLB at birth because his parents received the NCB supplement for that year. His parents continue to receive the NCB supplement for each year up to and including the year in which he reaches 15 years of age. This generates an entitlement to a $100 CLB for each of those years, and these funds are invested as they become available in Mathieu's RESP. Mathieu's RESP holdings earn an annual average real rate of return of 3.5 per cent. By the time Mathieu is ready to begin post-secondary education at age 18, the CLB will have grown to $3,000 (in 2004 dollars) in the RESP to help fund his post-secondary education.

Jennifer is also born in 2004. Her parents have family income above the NCB supplement range (greater than $35,000) in most years. However, they receive the NCB supplement for three years, when Jennifer is 4, 5 and 6 years of age. She is entitled to a first CLB of $500 at age 4, and an additional $100 CLB in each of the following two years. This $700 of CLB is invested in an RESP for her. When she is ready to begin full-time post-secondary education at age 18, the CLB will have grown to $1,120 (in 2004 dollars) in the RESP to help pay for post-secondary education costs.

The NCB supplement is paid on a 12-month benefit year cycle beginning in July based on family net income for the preceding tax year.

While no separate application will be required for the CLB, eligibility will be linked to entitlement for the NCB supplement, which is a component of the Canada Child Tax Benefit. It will be essential, therefore, that application be made for the Canada Child Tax Benefit in order for the child to be entitled to the CLB. Children for whom a Children's Special Allowance is paid will also be eligible for the CLB.

Entitlement to the CLB will be determined at the time of the first monthly payment of the NCB supplement in a benefit year in respect of a child. There will be only one CLB for a child in any particular benefit year. The CLB will be payable into an RESP of which the child is a beneficiary. While any person can subscribe to an RESP for the benefit of a child, only the primary caregiver for a child will be allowed to authorize the transfer of the CLB into an RESP for the benefit of the child. For purposes of the CLB, the primary caregiver in a particular year will generally be the person receiving the NCB supplement which generated entitlement for the CLB.

An additional $25 will be paid into the RESP to which the initial CLB of $500 is deposited in recognition of one-time incidental expenses that may be associated with opening the RESP account. As at present, the Social Insurance Number of each beneficiary must be made available to the RESP provider before an RESP can be established.

The CLB will be administered by the Department of Human Resources and Skills Development (HRSD). HRSD will keep track of CLB entitlements as they accumulate and record payments made for each child. A CLB in respect of a child can be transferred to an RESP at the request of a primary caregiver at any time before the child reaches 18 years of age. No interest will be paid on CLB entitlements that have not been transferred to an RESP—once in the RESP, the deposits will grow in accordance with the plan. If a CLB in respect of a child has not been transferred to an RESP by the time the child reaches 18 years of age, the child will have up to three years to open an RESP to hold the bond. In this case, the child will be both subscriber and beneficiary of the RESP. Once a child turns 21 years of age, any CLB in respect of the child which has not been transferred to an RESP will be forfeited.

The CLB will not be taken into account in calculating annual and lifetime RESP or CESG contribution limits. No CESG will be paid on CLB amounts placed in an RESP.

A specific portion of each Educational Assistance Payment will be considered to be attributable to the Canada Learning Bond. As at present, the full amount of the Educational Assistance Payment is subject to tax in the hands of the student. Conditions governing the use and repayment of the CLB will generally be the same as those applying to the CESG. However, CLB entitlements are allocated to a specific child and, unlike the CESG, cannot be shared with other beneficiaries in a family plan or group plan.

While it is proposed that the CLB be effective starting January 1, 2004, the first payment of the CLB will be made after Royal Assent to the enabling legislation and once delivery systems are put in place. Therefore, it is not expected that CLB payments will be made before January 2005.

HRSD and the RESP industry will work together to put in place, as soon as possible, the administrative arrangements needed to implement this program.

Canada Education Savings Grant

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 child who is under 18 years of age throughout a year is the beneficiary of an RESP, the first $500 contributed to the RESP in the year will attract:

- A 40 per cent CESG matching rate, if the child's family has qualifying net income in respect of the year of $35,000 or less.

- A 30 per cent 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.

All other contributions eligible for the CESG will continue to qualify for the 20 per cent matching rate. The $35,000 and $70,000 thresholds are in 2004 dollars and will be indexed to inflation for 2005 when this program comes into effect, and for subsequent taxation years.

For purposes of determining the CESG matching rates for a calendar year, qualifying net income in respect of the year will generally be defined as the family net income used to determine eligibility for the Canada Child Tax Benefit with respect to the child in January of that calendar year. This will be family net income for the second preceding calendar year.

To avoid additional administrative complexity and to encourage regular contributions to an RESP, the enhanced matching rates will apply to maximum contributions of $500 for a child in any given year—that is, there is no carry-forward of unused access to the enhanced CESG.

At present, the maximum annual CESG contribution room that any child can earn in a year is $2,000. The maximum CESG payable in respect of a year is $400. The maximum CESG contribution room will stay at $2,000. The maximum CESG payable in respect of a year, as well as the lifetime CESG limit for a child, will be increased to accommodate the enhanced matching rates, effective for 2005. A parent of a low-income family contributing $2,000 in a year could receive a CESG totalling $500—that is, 40 per cent on the first $500 ($200) and 20 per cent on the remaining $1,500 ($300).

Currently, where a child has accumulated sufficient unused CESG contribution room, subscribers may contribute up to $4,000 to the child's RESP in a year and will receive a CESG of $800 (that is, 20 per cent of $4,000). As a result of the enhanced CESG matching rates on the first $500 of RESP contributions in a year, qualifying subscribers contributing $4,000 in a year to catch up on unused CESG contribution room for the child of a low-income family may now receive a CESG of up to $900 in a year—that is, 40 per cent on the first $500 ($200) and 20 per cent on the remaining $3,500 ($700).

Parents, grandparents and other individuals may each establish RESPs for a child. Their contributions will generally attract the CESG, subject to the child's annual and lifetime CESG and RESP contribution limits. Their contributions may also be eligible for the enhanced CESG matching rates. However, where the RESP subscriber is not the primary caregiver (or his or her spouse or common-law partner), consent of the primary caregiver will be required before the enhanced CESG rate will be paid on contributions made by such subscribers. Unless consent is obtained, the CESG matching rate on eligible contributions will be 20 per cent. In all cases, the provision which limits the enhanced CESG matching rate to the first $500 contributed each year will apply jointly to all RESPs of which the child is the beneficiary.

It would not be appropriate to allow subscribers to withdraw existing RESP contributions and re-contribute them in order that their beneficiaries obtain a higher CESG matching rate. To prevent this, special rules will apply to withdrawals after March 22, 2004 for non-educational purposes of contributions which previously qualified for the CESG. Where such withdrawals occur, a 20 per cent CESG matching rate will apply to all eligible contributions made to any RESP in respect of those beneficiaries until the total level of contributions to RESPs for those beneficiaries returns to the level previously attained.

Educational Assistance Payments will be apportioned between the CLB, the CESG and the investment income earned in the RESP. As at present, all Educational Assistance Payments will be subject to tax in the hands of the student.

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.

Additional proposed rules relating to the CLB and enhanced CESG will be developed over the coming months. Further details will be released at a later date.

Some provinces may pursue the development and implementation of education savings incentive programs that are similar to the Canada Learning Bond or Canada Education Savings Grant programs. The Government is willing to explore with provinces the possibility of collaborating on the delivery of provincial programs consistent with those provided federally and of putting into effect administrative agreements to do so.

Taxation Arrangements with First Nations

In successive budgets since 1997, the Government has expressed its willingness to put into effect taxation arrangements with interested First Nations. To date, the Government has entered into taxation arrangements allowing nine First Nations to levy a tax on sales on their reserves of fuel, tobacco products and alcoholic beverages. Canada and the eight self-governing Yukon First Nations have also entered into personal income tax collection and sharing agreements. In 2003 the Government introduced legislation to provide the authority to interested First Nations to levy on their lands a First Nation Goods and Services Tax that is fully harmonized with the federal Goods and Services Tax (GST). The Government continues to indicate its willingness to discuss and put into effect direct taxation arrangements with interested First Nations.

The Government is also prepared to facilitate the establishment of taxation arrangements between provinces, territories and interested First Nations. The Government of Quebec has made such a request. The Government of Canada expresses its willingness to enable and facilitate the establishment of taxation arrangements between the Government of Quebec and interested Indian Act bands situated in Quebec.

Update—Taxation Issues

Tax Treatment of Savings

A tax system that encourages private saving is important both to support investment and economic growth and to allow Canadians to meet their individual savings needs. Budget 2003 announced increases in the registered pension plan (RPP) and registered retirement savings plan (RRSP) limits to $18,000 by 2005 and 2006 respectively. It also noted that it is important that the tax system continue to provide effective mechanisms to support saving. In this regard, it was stated that representations received on the tax treatment of savings would be reviewed and analysis conducted in order to identify possible approaches for future improvements. In particular, the Budget stated an intention to examine and consult on the question of whether tax pre-paid savings plans (TPSPs) could be a useful and appropriate additional savings vehicle for Canadians.

Finance officials consulted with interested groups, experts and academics on the tax treatment of savings and TPSPs. The discussions were helpful in gathering views on how the tax treatment of savings could be improved and on TPSPs in particular. The Department is reviewing the views brought forward and is continuing to examine and assess TPSPs and other approaches to improve the tax treatment of savings. In the consultation, the question of whether a new type of savings plan such as a TPSP could be appropriate for Canada raised a number of important issues which require further consideration.

Deductibility of Interest and Other Expenses

Interest and other expenses are generally deductible in computing income from a business or property only if the expense is incurred "for the purpose of earning income." As the 2003 Budget noted, the meaning of this phrase has become unclear, and in some respects it has been interpreted in a manner that could lead to inappropriate results. In particular, whether "income" is a gross or net concept, and whether "purpose" is subjective or objective, are questions that need to be addressed.

On October 31, 2003, the Department of Finance released for public consultation a package of legislative proposals respecting the deductibility of interest and other expenses. The proposal focused not on the deductibility of a particular expense, but rather on the ability of a taxpayer to claim a loss from a business or a property. In doing so, the proposals adopted the concept of the reasonable expectation of profit—one that is already used several times in the Act and that has been extensively considered in court decisions.

In its release, the Department emphasized that the sole intent of the proposals is to restore the law and related administrative practices to what they were generally understood to be in the past. Some commentators have nonetheless expressed concern that the proposals could have more far-reaching effects. While this is not the intention behind these proposals, a number of significant issues have been raised that deserve further consideration.

It is important to ensure that there is an adequate opportunity for taxpayers to comment on the proposals, and for the Department to consider those comments. Accordingly, the Department intends to extend the period for making written submissions on these proposals until the end of August of this year.

Cross-Border Share-For-Share Exchanges

Under the Income Tax Act, certain share-for-share exchanges can be undertaken on a tax-deferred basis where the corporations involved are all resident in Canada or are all non-residents. These rules do not apply, however, to a Canadian resident shareholder who exchanges shares of a domestic corporation for shares of a foreign corporation. While there may be other indirect means of accomplishing such an exchange on a tax-deferred basis, the resulting transactions can be complex and costly.

In the *October 2000 Economic Statement and Budget Update*, the Government 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. Budget 2003 reiterated this plan.

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 Minister of Finance announced his intention to propose changes to the Income Tax Act and other acts that will, among other things, establish a 10-year limitation period for the collection of federal tax debts. The proposed new limitation period responds to a Supreme Court of Canada decision that the collection of federal income tax debts was subject to the 6-year limitation period set out in the Crown Liability and Proceedings Act.

The Government intends, at an early opportunity, to place before Parliament amendments that would give effect to the changes proposed by the Finance Minister earlier this month.

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