AIM Trimark Investments federal budget analysis 2006

A leader in the timely and thorough preparation of tax information on a range of issues, AIM Trimark has been providing a customized analysis of the federal budget for nearly a decade. Prepared from within the budget lockup in Ottawa by Jamie Golombek, AIM Trimark's Vice President of Tax & Estate Planning, the 2006 edition selectively focuses on several specific budget elements that will have the biggest impact on your personal finances and investments.

GST and personal income tax cuts

As expected, the government announced that the GST rate would be reduced from 7% to 6%, effective July 1, 2006. The GST credit, which is available to low and medium-income individuals, will remain at its current levels and will not be reduced.

There were some pre-budget fears that to finance the GST cut, the Conservative Party would completely reverse the Liberals' previously-announced personal income tax cuts. In November 2005, the Liberals had announced their intention to lower the lowest tax bracket rate from 16% to 15% while simultaneously increasing the basic personal amount–the amount that Canadians can receive without paying any federal tax–by $500.

The Conservatives have taken the middle ground, leaving the 2005 lowest tax bracket at 15% but raising it to 15.25% for 2006 and to 15.5% for the 2007 tax year and beyond. The 15.25% rate for 2006 applies to taxable incomes below $36,378 and is also used to calculate most non-refundable tax credits, including the basic personal amount.

The basic personal amount for 2005 will remain at $8,648, as was previously announced by the Liberals. The basic personal amount will be $8,839 in 2006 and $8,739 plus the relevant indexation factor for 2007, ultimately rising to minimum of $10,000 by 2009. Personal amounts in relation to a spouse or common-law partner will also be adjusted.

The new "Canada Employment Credit"

Under the current tax rules, there is a huge inequity between employees and the self-employed when it comes to writing off work-related expenses. The current rules treat the self-employed or "independent contractor" much more favourably from a tax point of view, since a self-employed business person can take advantage of myriad tax deductions which are severely restricted for employees.

This issue came to the forefront in the 2004 Supreme Court of Canada ruling in Gifford, a case that dealt with a broker who was unable to deduct the cost of buying another broker's client list. Thomas Gifford was denied any deduction for the $100,000 he paid to purchase the client list. The Supreme Court publicly highlighted this unfairness, saying that, "… employees are treated differently than taxpayers earning income from business ... is not novel nor readily seen as fair ... This seemingly inequitable result for [Gifford] is the result of the structure of the [Income Tax] Act."

For example, consider the employee who purchases a home computer, used exclusively in the evenings and on weekends to check e-mail, conduct Internet research and prepare reports. Because of his employee status, he would not be entitled to any capital cost deductions associated with the computer since, under the current rules, employees are only allowed to depreciate automobiles or airplanes. Certainly, one would think that many more employees today use personal computers in the execution of their employment duties than use airplanes.

In recognition of this, the budget announced that beginning July 1, 2006, there will be a new tax credit available exclusively to employees called the "Canada Employment Credit." According to Finance Minster James Flaherty, "This new tax credit gives Canadians a break on what it costs to work, recognizing expenses for things such as home computers, uniforms and supplies."

The good news is that no receipts are required to justify any actual employment-related expenditures. In fact, no expenditures need actually be made at all. Instead, for 2006, the new credit will provide tax relief on the lesser of $250 and an individual's employment income for the year. For the 2007 and subsequent taxation years, however, the maximum amount on which the credit is calculated will be increased to $1,000.

Since it's a tax credit, the actual tax savings are calculated based on the lowest personal income tax rate for the taxation year (i.e., 15.25% for 2006 and 15.5% for 2007 and subsequent taxation years, as discussed above). The $1,000 amount will be fully indexed to inflation after 2007.

There is, of course, precedent for this credit. Prior to the 1987 Tax Reform, employees were entitled to claim a $500 basic employment expense deduction, meant to compensate employees for their non-deductible employment expenses. In 1998, a similar deduction was reinstated, now worth $1,000, but is limited only to certain emergency service volunteers such as rescuers, ambulance technicians and firefighters, and therefore does not benefit the average employee.

Pension income credit

Under the current tax system, individuals aged 65 and over are entitled to claim a $1,000 pension income credit for eligible pension income, which includes annuity payments under a registered pension plan, an RRSP or a deferred profit sharing plan, or payments out of an RRIF.

The budget proposes to double the maximum amount of eligible pension income that can be used in calculating the pension income credit from $1,000 to $2,000, effective for 2006.

Donations of publicly-listed securities and mutual funds to public charities

The government announced that it will be following through on its pre-election promise to encourage the donation of publicly-traded securities (including mutual funds and segregated funds) to charity by completely eliminating the tax on any accrued capital gains arising from the disposition to charity.

Almost ten years ago, the government introduced enhanced tax assistance for donations of publicly-listed securities to charities. Under the current (pre-budget) rules, if an individual donates eligible securities, only 25% instead of the usual 50% of any capital gains triggered on the sale of those securities must be included in the individual's income.

To encourage additional donations of listed, publicly-traded securities to charitable organizations and public foundations, the budget proposes to completely eliminate any capital gains tax payable on the donation of these securities to charities by reducing the capital gains inclusion rate for such donations to zero.

While there was some speculation that this donation rule would be retroactive to January 1, 2006, the federal government announced that these new rules will apply only to donations of eligible securities made on or after May 2, 2006.

For example, to understand the impact of these new rules, let's assume that Mark currently owns mutual funds that have a fair market value of $100,000 that he purchased many years ago for $20,000. He is considering donating these mutual funds to charity.

If he simply sold the mutual funds first, he would realize a capital gain of $80,000 and pay tax of about $18,000 on the gain, assuming a top marginal rate of about 45%. His net benefit, taking into account the value of the donation credit less the tax on the capital gain, would be about $27,000 (Column A).

Under the existing (pre-budget) rules, if he donated the mutual fund units directly to charity instead of disposing of them first, this $18,000 of capital gains tax would have been cut in half for a net tax benefit of $36,000 (Column B).

Under the new rules, since the capital gains tax would be eliminated altogether on the donation of the mutual funds to charity, and since Mark would still be entitled to his full tax receipt for the $100,000 contributed, his net benefit would be $45,000 (Column C).

	Cash donation (A)	In-kind donation Pre-budget (B)	In-kind donation Post-budget (C)
Fair market value of donation	$ 100,000	$ 100,000	$ 100,000
Adjusted cost base – (assumed)	($ 20,000)	($ 20,000)	($ 20,000)
Capital gain	$ 80,000	$ 80,000	$ 80,000
Taxable gain (50% vs. 25% vs. 0%)	$ 40,000	$ 20,000	0
Tax on capital gain (at 45%) (A)	($ 18,000)	($ 9,000)	0
Tax benefit of gift (at 45%) (B)	$ 45,000	$ 45,000	$ 45,000
Net tax benefit (A + B)	$ 27,000	$ 36,000	$ 45,000
Tax savings from donating "in-kind" instead of cash		**$ 9,000**	**$ 18,000**

New dividend rules

As was widely expected, the budget announced that the government will be proceeding with measures announced by the Liberals back in November 2005, which would enhance the gross-up and dividend tax credit for "eligible dividends."

"Eligible dividends" include any dividends paid in 2006 by either public corporations or Canadian-controlled private corporations whose income (other than investment income) is not subject to the low, small business deduction on the first $300,000 of annual active business income.

These new rules help to solve the classic "integration" problem that currently exists for individuals who receive dividends from public corporations. The principle of integration means that, in theory, an individual should be able to realize the same amount of cash after-tax by earning income personally or through a corporation.

The current "gross-up" and dividend tax credit system is based on a theoretical integration model that taxes corporate income at 20%. The current system, while not perfect, works pretty well in most provinces when it comes to private corporations that can take advantage of the small business tax rate which approximates 20% on the first $300,000 of "active income" (as opposed to passive or investment income).

Under the theoretical model, if you are in the top bracket and earn $100 of income personally and pay tax at the highest average tax rate in Canada of 46%, you would have $54 of cash left to spend.

If the same $100 was earned by a small business corporation eligible for the preferential corporate tax rate of 20%, the corporation would have $80 left after tax to pay to its shareholder as a dividend.

Under the current rules, the $80 of dividends received would be "grossed-up" by 25% to $100–the same amount of income the corporation earned pre-tax. The purpose of the gross-up, therefore, is to put the shareholder in the same position she would have been in had she earned the $100 personally.

That being said, to compensate the shareholder for the corporate tax already paid on the $100 by the corporation, the shareholder may claim a federal dividend tax credit of 13.33% of the grossed-up dividend and a provincial dividend tax credit which, on average, is worth about half the federal credit or about 6.67% (each province's rate is different).

The effect of the gross-up and tax credit is that the shareholder initially pays $46 of tax on the $100 of grossed-up dividends received. She then gets a 20% or $20 combined federal and provincial dividend tax credit which puts her net tax at $26 on an $80 dividend received, netting her after-tax cash of $54–the same as the after-tax proceeds if the $100 was earned directly. The resulting effective marginal tax rate on dividends is therefore 32.5% (Column 1 of chart).

This theoretical model currently fails when it comes to dividends paid by public companies which face a much higher corporate tax rate than 20%. You can see (Column 2) that the same $100 earned by a public company in Canada only nets the investor about $46 versus the $54 in the theoretical model.

Income trusts have long ago figured out a way to escape this double-tax problem experienced by Canadians on public company dividends–convert to a trust and eliminate corporate tax altogether.

In the budget, the government confirmed that effective in 2006, the gross-up would be enhanced to 45% (from 25%) and the federal dividend tax credit would then be increased to 19%. These rates are based on a combined average federal-provincial corporate tax rate of 32% in 2010.

Underlying these new rates is the assumption that the provinces and territories will also increase their dividend tax credits for eligible dividends to equal their general corporate income tax rates. That remains to be seen, as most provinces so far have taken a "wait-and-see" approach, delaying their announcements until after the Conservatives' announcement. If the provinces do follow, full integration will be achieved by 2010 and result in the average top marginal tax rate for dividends dropping to 20.3% (Column 3).

According to the government, "This tax reduction will encourage savings, investment and economic growth, and will make the total personal and corporate income tax on earnings distributed as dividends more comparable to the income tax paid on interest payments and income trust distributions."

Corporate integration models

		Theoretical model 1	Current model- Public corporations 2	New model- Public corporations 3
Income earned by corporation	A	100	100	100
Corporate tax (note 1)	B	20	32	32
Amount distributed as dividend	C	80	68	68
Gross-up		20	17	31
Amount included in income		100	85	99
Personal tax @ 46% (note 2)	D	46	39	45
Dividend tax credit (note 3)	E	(20)	(17)	(32)
Net personal tax	F	26	22	14
Net cash for investor	C-F	54	46	54
Total tax paid	B+F	46	54	46
Marginal tax rate	F/C	32.5%	32.5%	20.3%

Notes:
1. Assumes average federal-provincial corporate tax rate in 2010 is 32%
2. Assumes average top federal-provincial personal tax rate is 46%
3. Assumes provinces and territories increase their dividend tax credits to provide full integration

Tax breaks for students

The federal budget introduced two new tax breaks for students:

1. A "textbook tax credit"; and,
2. The complete elimination of federal tax on scholarships, fellowships and bursaries

Textbook tax credit

The new non-refundable textbook tax credit will assist students to offset the heavy burden often associated with the purchase of textbooks. The tax credit is calculated by multiplying the lowest personal income tax rate (i.e., 15.25% for 2006 and 15.5% for 2007 and beyond) by $65 for each month for which the student qualifies for the full-time education tax credit amount, or $20 for each month the student qualifies for the part-time education tax credit amount.

Just like education and tuition credits, any unused textbook tax credit amounts may be carried forward indefinitely to future years or may be transferred to a spouse, common-law partner, parent, or grandparent.

Scholarship and bursary income

Under the current rules, the first $3,000 of scholarship, fellowship or bursary income received by a student with respect to their post-secondary education or occupational training is exempt from tax.

The budget proposes full exemption for such scholarship, fellowship or bursary income from tax. The full exemption will only apply to amounts received while the student is enrolled in programs which entitle him or her to claim the education tax credit. This includes most programs at the post-secondary level as well as programs at educational institutions certified by the Minister of Human Resources and Social Development as providing occupational skills.

What's not in the budget?

In prior years, the government has used the budget as a way of updating Canadians about the status of proposed tax measures currently under consideration. Two such measures include the Conservatives' pre-election promise to eliminate tax on capital gains when proceeds from the sale of assets are reinvested within six months, and the long-outstanding and much-criticized draft legislation on losses and interest deductibility.

Unfortunately, neither was dealt with in the current budget.

For more information about this topic, contact your advisor,
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5140 Yonge Street, Suite 900, Toronto, Ontario M2N 6X7 • Telephone: 416.590.9855 or 1.800.874.6275
Facsimile: 416.590.9868 or 1.800.631.7008 • *inquiries@aimtrimark.com* **www.aimtrimark.com**