

Federal Budget 2004

March 23, 2004

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HEALTH, WEALTH AND LEARNING

By Tim Cestnick, Managing Director, and Suzanne Schultz, Associate Vice President, Tax and Estate Group, AIC Limited.

The 2004 federal budget represents the first for Finance Minister Ralph Goodale, and the first under a Liberal government led by Paul Martin. This year's budget represents the seventh consecutive balanced budget, despite the fact that economic activity slowed in 2003. Gross Domestic Product (GDP) grew by just 1.7% in 2003, a lower figure than the 3.2% growth that had been forecast by the private sector at the time of last year's federal budget. Greater growth of 2.7% is expected in 2004 due to solid domestic fundamentals, lower interest rates and an expected stronger U.S. economy.

For 2003-04, a federal surplus of \$1.9 billion is expected (down from a surplus of \$7 billion in 2002-03). This budget maintains the annual \$3 billion contingency reserve and restores \$1 billion in economic prudence in 2004-05 and 2005-06 to provide greater assurance that the rolling two-year balanced budget targets will be met. The contingency reserve will be used to pay down the federal debt if it's not needed to deal with unforeseen circumstances.

At the time of writing, our federal debt is \$504 billion. That's approximately \$15,950 of debt for every man, woman, and child living in Canada. The federal debt-to-GDP ratio in 2003-04 is expected to be 42%, down from a peak of 68.4% in 1995-96. The intention of the government is to bring this ratio down to 25% within 10 years, in order to be in a better position to deal with pressures relating to an aging population.

The 2004 federal budget focuses its attention on three key areas: Health care, education and a balanced budget.

In the area of health care, this budget confirms:

- An additional \$2 billion for the provinces and territories for health, bringing to \$36.8 billion the funding provided under the February 2003 First Ministers' Accord on Health Care Renewal.
- Establishment of a new Canada Public Health Agency as a focal point for disease and emergency response, with immediate funding of \$665 million (in addition to \$400 million to be transferred from Health Canada to the new agency).

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As for education measures, the highlights include:

- A new Canada Learning Bond, providing up to \$2,000 for children in low-income families born after 2003 for post-secondary education.
- Enhancements to the Canada Education Savings Grants for low- and mid-income families.
- New grants of up to \$3,000 for first-year, post-secondary dependent students from low-income families, and up to \$2,000 for post-secondary students with disabilities.
- Increase in the ceiling for Canada Student Loans to \$210 per week (up from \$165), and improved interest and debt relief available to students facing financial difficulty.

As always, there are personal and business tax changes in the budget. We'll discuss those changes now.

Personal Tax Measures

The following are measures that impact individuals and their tax liabilities.

Tax Fairness for Persons with Disabilities

Following years of changes and confusion surrounding the tax benefits available to those with disabilities, the government did not announce any major changes to the disability tax credit in this budget. This budget did announce one beneficial change, however. The attendant care deduction is to be replaced in 2004 and subsequent years with a broader "disability supports deduction" that will allow a deduction from net income for the costs of certain services or devices incurred to allow the disabled person to go to work or to school. Some examples include sign-language interpretation services, talking textbooks, attendant care services and tutoring services. The effect of this measure is that there will be enhanced deductibility for the expenses and the income will not be used in determining the value of income-tested benefits.

Medical Expenses for Dependent Relatives

Under this measure, the ability to claim the medical expense credit for a dependant is increased. In the past, if the dependent relative's net income exceeded the basic personal amount, the amount of medical expenses claimable was reduced by 4.25 times that amount. This, in many cases, completely eliminated the medical expense

credits. Beginning in 2004, if the expenses are incurred for a minor child, that child's income will not be used to claw back the credit. For other dependent relatives, such as a parent, medical expenses in excess of the lesser of 3 per cent of the dependant's net income and \$1,813 will be allowable.

Education Tax Credit

It was proposed that the education tax credit be available to students who pursue post-secondary education that is related to their current employment, unless all or a part of the costs of education were reimbursed by the employer.

Income Trusts

After some weeks of speculation, and an outcry from Bay Street, the budget announced the status quo for personal investors in income trusts. Likewise, there will be no changes to the tax rules if income trusts are held in an RRSP or RRIIF.

What has been proposed, however, is that pension funds be limited in their investment in "restricted investment property" beginning after 2004. Since income trusts themselves are not taxable, but rather they flow the tax exposure on to their investors, the concern is that if pension funds (which are not taxable) begin investing in these trusts, there could be a major loss of tax revenue. Restricted investment property would include direct holdings of business income trusts and vehicles, such as mutual funds, that invest in these trusts and therefore give the pension fund indirect exposure to these investments. It will not include resource royalty trusts and REITs. Pension funds will be restricted to investing no more than 1 per cent of the book value of assets in these restricted investment properties, and a pension fund cannot own more than 5 per cent of the outstanding units of any business income trust.

Non-Residents' Investment Through Mutual Funds

Currently, capital gains are taxed in a person's country of residence. This means that a non-resident earning Canadian capital gains would not be subject to Canadian withholding tax on those gains. There is an exception for "taxable Canadian property" (TCP), which is subject to Canadian taxation. TCP includes such items as real property situated in Canada and Canadian resource

property. The problem is that if a mutual fund holds TCP and then makes a capital gains distribution to non-resident investors, the gains are not taxable within the fund, nor is there a mechanism to withhold tax on those gains. The budget has proposed a 15 per cent withholding tax to remedy this disparity, applying to gains realized by a fund after March 22, 2004. Gains on sale are not subject to this withholding, and any losses on sale can be used to offset the distributions on which the new withholding tax is applied, potentially providing a tax refund to the investor.

Improved Information Reporting

Trusts making distributions to beneficiaries that will increase the cost base of the beneficiary's interest in the trust, will be required to disclose that fact to the beneficiary for 2004 and subsequent years. This will impact investors who receive distributions from mutual funds since it will now be clear which of those distributions should be used to increase or decrease the cost base of the investment, and therefore ensure the capital gain or loss calculated by the client on disposition of the investment is correct.

General Anti-Avoidance Rule (GAAR)

The budget proposed to clarify that GAAR applies to a misuse or abuse of the provisions of and enactments to amend all of the following: the Income Tax Act, the Income Tax Regulations, the Income Tax Application Rules and tax treaties.

Affiliated Persons Rules and Trusts

The affiliated persons rules in the Income Tax Act apply in many situations, including situations where losses are claimed. Currently you are considered to be affiliated with yourself, your spouse, a corporation you control and a partnership you are a partner of, so that losses on transfer of property to those affiliated with you are denied. Likewise, where an affiliated person reacquires, within 30 days, an investment you have sold at a loss, your loss is denied. Trusts had previously not been included in these rules since they were not affiliated with any person. The budget proposes to expand the scope of the affiliated persons rules beginning March 23, 2004 so that a trust will be affiliated with any of its beneficiaries who are entitled to a majority of the trust income or capital. This will negatively impact the strategy where a taxpayer sells

an open investment in order to trigger a capital loss, but then repurchases that same investment in a registered account within 30 days. Under the budget proposal, the taxpayer's loss would be denied in this situation under the superficial loss rules.

Taxpayer-Requested Adjustments

Currently taxpayers are allowed to late-file a tax return, or request beneficial changes to past tax returns, for years back to 1985. The budget proposes to limit the late filing to taxation years that end in any of the 10 preceding calendar years. This will affect those taxpayers who were entitled to certain tax credits, such as the disability tax credit, age credit or provincial tax credits, among others, but did not file for these credits on their personal tax returns. This measure is to come into effect after 2004, meaning it is important for all taxpayers to review their old tax returns, perhaps with the help of a tax professional, before the end of this year to see if there were any credits missed.

Charities

A number of measures concerning charities were announced in the budget. As far as individuals are concerned, there will be more information available as to the registration status of a charity so that donors can be assured that a tax receipt (if that is what they want) is valid. Also, starting in 2004, official receipts are required to include the CRA's name and website address, where much of this information can be found.

Tax Relief for Canadian Forces Personnel and Police

Members of the Canadian Forces or a Canadian police force serving on a deployed operational mission who receive certain "risk allowance" payments, will be entitled to deduct the amount of employment earnings from that mission from their taxable income.

Education

A number of measures that will positively impact students and their families were proposed in the budget. Specifically:

- **Canada Learning Bond.** Each child born on or after January 1, 2004 will be eligible for this bond in each year that the child's family is entitled to the National

Child Benefit supplement, up to and including the year in which the child turns 15. A child qualifying in each year will be entitled to an amount of \$100 per year (\$500 in the first year) and could accumulate payments of \$2,000 in total. These payments will go into an RESP for the child, and therefore can be invested for capital growth.

- **Canada Education Savings Grant (CESG).** Low- and middle-income families who make contributions to an RESP will benefit from proposals that will increase the CESG in certain situations. Specifically, the first \$500 contributed to the RESP in a year will attract a 40-per cent CESG if the child's family has income of \$35,000 or less, and a 30-per cent matching rate if income is between \$35,000 and \$70,000. All other contributions to an RESP will continue to qualify for the 20 per cent CESG.

Tax Pre-Paid Savings Plans (TPSPs)

It was speculated that there might be a budget announcement regarding TPSPs to help encourage private saving. Although there were no specific measures regarding this, there was mention that this matter is still being considered. These plans will be similar to RRSPs, except that no deduction will be allowed on contributions, and no tax would apply to withdrawals.

Interest Deductibility

The topic of interest deductibility has been on the forefront of issues affecting investors in recent years. In 2003 the issue became further muddled when the CRA came out with a draft Interpretation Bulletin on interest deductibility, followed by the Department of Finance's draft legislation in the Income Tax Act that was in contradiction to the CRA's position. As it reads, the current draft legislation would prevent the deduction of interest in cases where there is no reasonable expectation that cumulative profits from the leveraged investment (or business) will exceed the interest costs. For these purposes, income does not include capital gains. Many Canadian taxpayers and industry groups were outraged by this draft legislation and accordingly, the Department of Finance has agreed to further study the issue. It was announced as part of the budget that written submissions on these proposals will be extended and will now be accepted up until the end of August 2004.

Limitation Periods for Federal Tax Debts

Due to a recent Supreme Court of Canada decision, the collection of federal income tax debts was held to be limited to a six-year period. This was welcome news (for those taxpayers with old, outstanding tax debts) that was short-lived. The government addressed this issue in the budget and stated that it intends to enact legislation to establish a 10-year limitation period for the collection of federal tax debts.

Business Tax Measures

The following represent tax measures in the 2004 budget affecting business owners.

Small Business Deduction Limit

Canadian controlled private corporations (CCPCs) enjoy a lower rate of tax (about 18 per cent) on the first \$250,000 (in 2004) of active business earnings in a year, due to the "small business deduction." The 2003 budget proposed to phase in increases to the small business limit, essentially increasing the amount of income subject to the lower rate of tax. The 2004 budget proposes to accelerate the increase in the small business limit by one year, meaning that the limit will be \$250,000 in 2004 (as previously announced), but \$300,000 in 2005 and subsequent years.

SR&ED

The tax rules around Scientific Research & Experimental Development (SR&ED) credits have been relaxed. The budget proposes to amend the rules so that small CCPCs that have a group of common investors 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. This will apply to tax years that end after March 22, 2004.

Business Losses

Recognizing that new small businesses can have losses for a number of years during their start-up phases, the budget proposes to increase the loss carry forward period of non-capital losses from seven years to 10 years. The carryback period remains at three years. Unused foreign tax credits can likewise be carried forward for 10 years under this proposal. This measure applies to all taxpayers for taxation years that end after March 22, 2004.

Capital Cost Allowance (CCA) Rates

CCA, or tax depreciation, is meant to allow taxpayers to write off assets used in a business over their useful lives. Due to the fast pace of technological change, the CCA rate for computer equipment will be adjusted from 30 per cent to 45 per cent. The CCA rate for data network infrastructure equipment will be adjusted from 20 per cent to 30 per cent. This measure applies to equipment acquired after March 22, 2004.

Fines and Penalties

Our tax law generally allows a deduction for expenses incurred for the purpose of earning income from a business. Recent court decisions have supported the notion that fines and penalties (not including tax fines and penalties) are generally deductible if incurred for the purpose of earning income. It seems that the government was not content with this result. For all fines and penalties incurred after March 22, 2004, the budget proposes to disallow deductions for any fines and penalties imposed by virtually any law, including the laws of other countries, with few exceptions. Fines and penalties resulting from a private contract would be excluded from these rules.

The Bottom Line

The 2004 federal budget offered little to taxpayers – good or bad. This budget simply resulted in some housekeeping; closing some perceived loopholes; and commenting a little on the issues under review at the Department of Finance (specifically, the Tax Pre-Paid Savings Plans and interest deductibility).

The bad news for taxpayers is perhaps this: The current government seems intent on offering little or no tax relief for at least the next two years. The reason? Budgetary revenues are estimated at 14.9% of GDP in 2003-04 – the lowest level since the early 1960s. And this percentage is expected to decline over the next two years. The suggested reason for this decline in revenue is the tax cuts that were presented in budgets in the past five years.

For the time being, we will simply have to learn to enjoy the tax savings offered by tax cuts made in recent years.

If you have any questions regarding the contents of the 2004 Federal Budget, simply contact the AIC Tax and Estate Group at 1-866-TAX-SMRT (829-7678), or by e-mail at taxsmart@aic.com

Canadian provinces and territories impose their own tax rates in addition to the federal tax rates. Therefore, depending on where an investor lives, that individual's tax rate may differ from any examples shown. The content of this article is for informational purposes only and in no way should be construed as tax advice. Please consult a professional tax advisor for tax advice related to your specific situation.

AIC's STRATEGY FOR SUCCESS:

BUY.

A simple summary of our approach to mutual funds at AIC is this: choose the right heroes and keep the faith. We buy into excellent companies – the best of the best – in strong, long-term growth industries and we hold these investments for the long run. The goal is a better rate of return for our clients.

HOLD.

Stand for nothing and you are likely to fall for everything. The truth is, bears, bulls and other unpredictable market influences eventually disappoint short-term investors who focus on share prices rather than a company's true worth. At AIC, we stick with the quality businesses in which we invest.

AND PROSPER.

Prosperity to us means meeting the three objectives of investing. It means preserving your principal over the long term. It means growing your money at a good rate. And it means protecting your investment from the ravages of taxes. It's really quite simple. And the results over the long term are something to behold. Of course, what you do with your prosperity in the end is up to you.

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04-0476-E(03/04)