CHRISTMAS IN JULY? CORPORATE TAX REDUCTIONS UNVEILED

May 2006

On May 2, 2006, federal Finance Minister Jim Flaherty delivered the inaugural budget of the new Conservative Government. The Budget proposes the enactment of many of the tax-related proposals made by the Conservative Party during the most recent election campaign, while also introducing certain additional tax and spending measures. Minister Flaherty took an hour to deliver a 30-minute speech, due largely to almost constant calls for "more more" from the Parliamentary benches. With many of the tax credits and cuts timed to take effect on July 1, 2006, the Budget promises taxpayers Christmas in July.

The corporate tax highlights of the 2006 Federal Budget include the following:

General Corporate Income Tax Reductions

The Budget proposes a series of reductions to the general federal corporate income tax rate, which currently stands at 21%. The corporate tax rate will be reduced to 20.5%, effective January 1, 2008 and thereafter to 20%, effective January 1, 2009, and 19% effective January 1, 2010. The proposed rate reductions will only apply to income that is taxed at the general corporate tax rate. (Income taxed at the general corporate tax rate does not include small business income that is already eligible for the small business deduction; certain investment income of Canadian-controlled private corporations (CCPCs); the income of credit unions already eligible for certain corporate tax rate reductions; and the income of mutual fund corporations, mortgage investment corporations, most deposit insurance corporations, and investment corporations.)

Elimination of the Corporate Surtax

The federal corporate surtax applies to all corporations and is levied at a rate of 4% of the federal corporate income tax payable by a corporation, prior to claiming certain tax credits, but after taking account of the 10% federal abatement for income earned in a province. As of 2008, small and medium-sized corporations were already scheduled to no longer be subject to the corporate surtax. The Budget proposes to completely eliminate the corporate surtax for all remaining corporations, effective January 1, 2008. The elimination of the corporate surtax is equivalent to a 1.12% reduction in corporate income tax rates.

Extension of Non-capital Loss and Investment Tax Credit Carry-Forwards

Currently, non-capital losses and investment tax credits (ITCs) can be carried back up to 3 years and carried forward 10 years by Canadian taxpayers. Consistent with proposals made by the previous federal government, the Budget proposes to extend the non-capital loss and ITC carry-forward period to 20 years for losses incurred and credits earned in taxation years that end after 2005. The extended carry-forward periods will apply to non-capital losses, farm losses, restricted farm losses, losses applied under Part IV of the Income Tax Act, and Canadian life investment losses under Part XII.3 of the Income Tax Act. In addition, the extended carry-forward period will apply to ITCs earned for scientific research and experimental development, Atlantic investment, and mineral exploration.

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Increase in Small Business Limit and Small Business Deduction

At present, the first $300,000 of qualifying active business income earned by a CCPC is generally subject to tax at the reduced small business tax rate of 12%. The Budget proposes to increase the amount of eligible income to $400,000 as of January 1, 2007. The Budget further proposes to reduce the small business tax rate to 11.5% beginning in 2008 and 11% as of January 1, 2009. Current rules regarding the allocation of the small business limit among associated corporations and the phase out of the small business deduction for CCPCs having at least $10 million of taxable capital employed in Canada will remain intact.

To coincide with the increase in the small business limit, the enhanced scientific research and experimental development investment tax credits that may be earned by a CCPC may now only begin to be reduced when a CCPC's taxable income for the previous taxation year exceeds $400,000.

Elimination of the General Capital Tax

The federal capital tax was first introduced as a temporary deficit reduction measure in 1989. Federal capital tax (also known as the "Large Corporations Tax") is levied at a rate of 0.125% on the taxable capital of a corporation in excess of $50 million. A corporation's taxable capital generally consists of the total of its shareholders' equity, surpluses and reserves, plus loans and advances to the corporation, less certain types of inter-corporate investments.

The Large Corporations Tax had previously been legislated to be eliminated in 2008. However, proposals by the previous Liberal government had been announced that would have eliminated the tax as of January 1, 2006. The Budget proposes to carry out the former government's pledge and eliminate the Large Corporations Tax retroactive to the beginning of 2006.

Amendments to the Minimum Tax on Financial Institutions

In 1986, a federal capital tax on financial institutions was introduced to serve as a minimum tax for banks, trust companies and mortgage loan companies. The application of the tax was extended to life insurance companies in 1990. The federal capital tax on financial institutions stood independent of the Large Corporations Tax.

The Budget proposes to alter and simplify the application of the capital tax on financial institutions by applying the tax only to those institutions with taxable capital employed in Canada of at least $1 billion. A single tax rate of 1.25% will be applied on taxable capital employed in Canada in excess of $1 billion. These proposed changes, if enacted, will apply beginning on July 1, 2006.

Consideration of Functional Currency Tax Reporting

Taxpayers are currently required to report their income for Canadian tax purposes in Canadian dollars. This requirement can be particularly burdensome for Canadian-resident corporations that conduct their business activities primarily in a foreign currency and are required to determine income for accounting purposes in that foreign currency. The Budget proposes to initiate an investigation by the Department of Finance to determine whether it will be feasible to allow such corporations to report their income for tax purposes in a currency other than the Canadian dollar.

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Enhanced Dividend Tax Credit Confirmed

In November of 2005, the former Liberal government announced measures to address the Canadian government's growing concern with the potential loss of tax revenue arising from the use of income trust structures and other types of flow-through entities. In the November 2005 announcement, the Minister of Finance stated that the overwhelming consensus among the submissions that had been received was to reduce personal income taxes on dividends in order to make corporate investment structures more competitive with income trusts.

The proposed mechanism for the tax reduction was to take the form of an enhanced dividend "gross-up" and tax credit, such that the total tax on dividends received from large Canadian corporations would be comparable to the tax paid on distributions from income trusts.

The enhanced dividend gross-up and tax credit would apply to "eligible dividends". Eligible dividends were generally proposed to include dividends paid after 2005 by public corporations (and other corporations that are not CCPCs) that are resident in Canada and subject to the general corporate income tax rate. CCPCs would be able to pay eligible dividends to the extent that their income (other than investment income) is subject to tax at the general corporate income tax rate.

The Budget confirmed the Government's intention to introduce amendments to the Income Tax Act consistent with the previous government's proposal. Therefore, shareholders will be required to include 145% of the amount of eligible dividends received in a year in their respective incomes and will, thereafter, be entitled to claim a federal dividend tax credit in respect of such eligible dividends equal to approximately 19% of the grossed-up amount.

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

For further information, or to discuss how the 2006 Federal Budget may impact you or your business, please contact any member of the McMillan Binch Mendelsohn LLP Tax Group listed below:

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