

Federal Budget Report

Highlights

- *\$10.2 Billion Debt Repayment in 2007/08*
- *New Tax-Free Savings Account Introduced*
- *Rules for Dispositions of Taxable Canadian Property Streamlined*
- *SR&ED Enhancements for Small and Mid-Sized Businesses*

“Responsible Leadership For Uncertain Times”

Today, the Honourable Jim Flaherty tabled his third budget as Minister of Finance. Faced with a slowing economy, particularly in Quebec and Ontario, and the fact that the Conservatives introduced major tax cuts in the Fall 2007 Economic Statement, the measures introduced in this budget were very modest. Politically, it appears that the government will survive for now, as the Liberal Party announced shortly after the budget was tabled that they would not trigger an election over the budget.

The projected surplus for the 2007-08 fiscal year, originally forecast to be \$300 million after a \$3 billion planned debt reduction, is now expected to be \$10.2 billion – all of which will go to debt reduction. For the 2008-09 fiscal year, a balanced budget is forecasted, after budgeted debt reductions of \$2.3 billion.

On the spending side, the government did little with very modest spending initiatives. In positive news for municipalities, the Gas Tax Fund, to be worth \$2 billion in the 2009-10 fiscal year, has been made permanent, which will help municipal governments deal with their infrastructure needs. The government also announced today the creation of the Canada Employment Insurance Financing Board, an independent Crown corporation with a legislated structure which provides that Employment Insurance (EI) premiums are dedicated exclusively to the EI program and cannot be used to finance other government spending.

As expected, the budget did not contain any significant tax relief for either individuals or businesses. The temporary increase to the tax depreciation rates for acquisitions of capital assets in the manufacturing sector has been extended in an effort to encourage investment. There were also enhancements to research and development tax credits for Canadian controlled private corporations. On the personal side, the centerpiece of the budget was the introduction of Tax-Free Savings Accounts, which will assist Canadians to save on a tax efficient basis. However, investors who were hoping to see capital gains tax relief as promised by the Conservatives in the 2006 election campaign were again disappointed.

The following is a summary of the more important items of interest to our clients.

Key Economic Statistics

<i>Surplus (in billions \$)</i>	<i>2007-2008 Revised</i>	<i>2008-2009 Projected</i>	<i>2009-2010 Projected</i>
Budgetary Revenue	244.5	241.9	252.0
Program Spending	201.2	208.1	218.3
Operating Balance	43.3	33.8	33.7
Public Debt Charges	33.1	31.5	32.4
	10.2	2.3	1.3
Planned Debt Reduction	10.2	2.3	1.3
Remaining Surplus	–	–	–
Net Public Debt	457.1	454.8	453.5

Personal Tax Measures

Tax-Free Savings Account

In the 2003 budget, the Government announced that they intended to review and consult with respect to various issues in order to assess whether Tax Pre-Paid Savings Plans could be a useful and appropriate mechanism to provide additional savings opportunities for Canadians. The 2008 budget proposes to introduce the Tax-Free Savings Account (TFSA).

Beginning in 2009, any individual (other than a trust) who is resident in Canada and 18 years of age or older will be eligible to establish a TFSA. Contributions will be allowed up to the contribution room available. Starting in 2009, individuals 18 years of age and older will acquire \$5,000 of TFSA contribution room each year. In future years, the \$5,000 limit will be indexed to inflation and rounded to the nearest \$500. Unused contribution room will be carried forward to future years with no limit on the number of years that unused contribution room can be carried forward and any amounts withdrawn will be added to the contribution room for the following year.

While contributions to a TFSA will not be tax deductible, income, losses and gains in respect of investments held within a TFSA, as well as amounts withdrawn, will not be included in computing income for tax purposes or taken into account in determining eligibility for income-tested benefits or credits such as the Canada Child Tax Benefit, the Goods and Services Credit, the Age Credit, Old Age Security benefits, the Guaranteed Income Supplement or Employment Insurance benefits.

A TFSA will generally be permitted to hold the same investments as an RRSP. Similar to an RRSP, interest on money borrowed to invest in a TFSA will not be tax deductible.

The tax assistance provided by a TFSA is, in many ways, a mirror image of that provided through RRSPs:

- RRSP contributions are tax deductible, with both the contributions and the investment earnings taxable upon withdrawal.
- TFSA contributions are made from after-tax income, with both the contributions and the investment earnings exempt from tax upon withdrawal.

The table on the next page shows that the net after-tax rates of return on TFSA and RRSP savings are equivalent when effective tax rates are the same at the time of contribution and withdrawal.

<i>Net Proceeds from Saving in a TFSA Relative To Other Savings Vehicles (Source: Department of Finance)</i>			
	<i>TFSA</i>	<i>RRSP</i>	<i>Unregistered Savings</i>
Pre-tax income	\$1,000	\$1,000	\$1,000
Tax (40% rate)	400	–	400
Net contribution	600	1,000	600
Investment income (20 years at 5.5%)	1,151	1,918	707 ¹
Gross Proceeds (Net contribution + investment income)	1,751	2,918	1,307
Tax (40% rate)	–	1,167	–
Net Proceeds	\$1,751	\$1,751	\$1,307
Net annual after-tax rate of return ² (%)	5.5	5.5	4.0

¹ For the unregistered saving case, tax rate on investment income is 28%, representing a weighted average tax rate on an investment portfolio comprised of 30% dividends, 30% capital gains and 40% interest.

² Measured in relation to forgone consumption of \$600. Assumes annual nominal pre-tax rate of return is 5.5% invested for 20 years.

Dividend Taxation Changes

In last fall's Economic Statement, significant reductions were made to the general corporate income tax rate. Under the dividend taxation rules, after-tax general rate corporate income can generally be paid as an eligible dividend to shareholders. Given the underlying corporate tax will decline significantly over time, the federal eligible dividend gross-up and dividend tax credit that apply to individuals will also be reduced, as follows:

<i>Eligible Dividend Gross-up and Tax Credit Adjustments</i>					
	<i>2008</i>	<i>2009</i>	<i>2010</i>	<i>2011</i>	<i>2012</i>
Existing Rules:					
- Gross -up	45%	45%	45%	45%	45%
- Dividend tax credit*	19%	19%	19%	19%	19%
Proposed Rules:					
- Gross-up	45%	45%	44%	41%	38%
- Dividend tax credit*	19%	19%	18%	16.5%	15%

* Expressed as a percentage of the taxable (grossed-up) amount of the eligible dividend.

Registered Education Savings Plans

Currently, contributions to an RESP can be made for 21 years following the opening of the plan. An RESP must be terminated by the end of the year that includes the 25th anniversary of the opening of the plan. Also, no contributions may be made to a family plan for a beneficiary who is 21 years of age or older. The budget proposes an increase to each of these three limits by an additional 10 years.

At present, RESP beneficiaries are eligible to receive Educational Assistance Payments (EAPs) from the plan if, at the time of the payment, they are enrolled as a student in a qualifying post-secondary program. The budget proposes to allow RESP beneficiaries to receive EAPs for up to six months after ceasing to be enrolled in a qualifying program. This measure will apply to RESP beneficiaries who cease to be enrolled in a qualifying program after 2007.

Mineral Exploration Tax Credit

The Mineral Exploration Tax Credit is available to individuals who invest in flow-through shares and is equal to 15% of the specified mineral exploration expenses incurred in Canada and renounced to individual investors. This temporary credit is scheduled to expire at the end of March 2008. The budget proposes to extend the eligibility for the mineral exploration tax credit to flow-through share agreements entered into on or before March 31, 2009.

***Capital Gains and Donations:
Exchangeable Securities***

Currently, when a taxpayer donates certain publicly-traded securities to a registered charity or other qualified donee, the full value of the security is eligible for a donation credit and any gain on the security is exempt from capital gains tax. For donations made on or after February 26, 2008, the budget proposes to extend the capital gains tax exemption to capital gains realized on the exchange of certain unlisted securities for publicly-traded securities, when the publicly-traded securities are then donated within 30 days of the exchange.

***Registered Disability
Savings Plans***

The 2007 budget introduced the Registered Disability Savings Plan to help parents save to ensure the long-term financial security of a child with a severe disability. The Government is working with financial institutions to put the necessary administrative mechanisms in place with the objective that plans be made available in 2008. To qualify as a beneficiary, the individual must be eligible to claim the Disability Tax Credit. If the beneficiary ceases to be eligible for the credit, the rules require that the proceeds of the plan be paid out to the beneficiary and the plan collapsed. Concerns have been raised over the possibility that the beneficiary who continues to meet the disability tax credit criteria might be able to force the premature collapse of the plan by rescinding his or her certification. The 2008 budget proposes to amend the rule to provide for a mandatory collapse of the plan only where the beneficiary's condition has factually improved to the extent that the beneficiary no longer qualifies for the disability tax credit. This measure will be effective for 2008 and subsequent taxation years.

Medical Expense Tax Credit

The Medical Expense Tax Credit recognizes the effect of above average specific medical and disability-related expenses on an individual's ability to pay tax by providing relief equal to 15% of the eligible medical and disability-related expenses in excess of a threshold. The budget proposes to expand the list of eligible expenses by adding altered auditory feedback devices for the treatment of a speech disorder; electrotherapy devices for the treatment of a medical condition or severe mobility impairment; standing devices for standing therapy in the treatment of severe mobility impairment; and pressure pulse therapy devices for the treatment of a balance disorder. The budget also proposes to extend the eligibility of costs associated with service animals specially trained to assist an individual who is severely affected by autism or epilepsy. The budget also clarifies the wording to ensure that drugs and medications purchased without a prescription after February 26, 2008 are ineligible for the credit. The amendment to expand the list of eligible expenses will be effective for the 2008 and subsequent taxation years.

Northern Residence Deduction

Individuals who live in prescribed areas in northern Canada for at least six consecutive months beginning or ending in a taxation year may claim the northern residence deduction. The budget proposes to increase the residency deduction by 10% increasing the maximum deductions to \$8.25 per day per person or \$16.50 per day if only one member of the household makes the claim. This amendment will apply to the 2008 and subsequent taxation years.

Business Income and Other Tax Measures

Scientific Research and Experimental

Development (SR&ED) Program

Changes for Small and Medium-Sized Businesses - For taxation years ending after February 25, 2008, the budget proposes to:

- increase the expenditure limit, eligible for the enhanced Investment Tax Credit (“ITC”) rate of 35%, from \$2 million to \$3 million;
- increase the upper limit of the phase-out range of the annual expenditure limit for prior year taxable income to \$700,000 from \$600,000. (The expenditure limit will continue to be reduced by \$10 for each \$1 by which taxable income for the previous taxation year exceeded \$400,000); and
- increase the upper limit of the phase-out range for prior-year taxable capital to \$50 million from \$15 million.

SR&ED Carried On Outside Canada - Currently, expenditures incurred on SR&ED carried on outside Canada do not qualify for the ITC. The budget proposes to extend the ITC to certain activities carried on outside Canada, which are done solely in support of SR&ED activities carried on by the taxpayer in Canada. In particular, an ITC will be available for certain salary or wages incurred by a taxpayer in respect of Canadian-resident employees carrying on SR&ED activities outside Canada. Expenses eligible will be limited to a maximum of 10% of the Canadian SR&ED labour expenditure. This proposal will apply to salary or wages incurred by a taxpayer in respect of SR&ED carried on outside Canada on or after February 26, 2008 subject to proration for the first taxation year ending after February 25, 2008.

Manufacturing and

Processing: Accelerated CCA

In the 2007 budget, a temporary capital cost allowance (CCA) incentive was introduced for eligible machinery and equipment acquired on or after March 19, 2007 and before 2009. Instead of being eligible for the 30% declining-balance CCA rate that normally applies, these assets are eligible for a 50% straight-line CCA rate.

The 2008 budget proposes to extend the accelerated CCA treatment for investment in the manufacturing and processing sector for three additional years. This will include a one-year extension of the 50% straight-line accelerated CCA, followed by a two-year period during which accelerated CCA will be provided on a declining basis. Businesses will now be allowed to apply the current accelerated 50% straight-line CCA treatment to investments in manufacturing and processing machinery and equipment acquired in 2009. Eligible assets acquired in 2010 will generally be eligible for a 50% declining-balance rate in the first taxation year ending after the assets are acquired, a 40% declining-balance rate in the following taxation year and the regular 30% declining-balance rate thereafter. Eligible assets acquired in 2011 will generally be eligible for a 40% declining-balance rate in the first taxation year ending after the assets are acquired and the regular 30% declining-balance treatment thereafter. The 30% declining-balance rate will apply to all qualifying assets acquired after 2011. The “half-year rule” will apply to assets that are eligible for the enhanced CCA rate.

Clean Energy Generation:

Accelerated CCA

The income tax system currently provides accelerated CCA (50% per year on a declining-balance basis) for specified clean energy generation equipment acquired before 2020. The budget proposes the following measures to expand the list of eligible equipment, which will apply to eligible assets acquired on or after February 26, 2008:

Ground Source Heat Pump Systems – The budget proposes to include Ground Source Heat Pump (GSHP) systems used in applications other than industrial processes or greenhouses, such as space and water heating (but not including swimming pool heating) in industrial, commercial and residential buildings used for an income-earning purpose. Qualifying system equipment will include underground piping systems, heat pumps, and ancillary equipment. Back-up energy equipment that supplements a GSHP system and equipment that distributes energy within a building will not be included. Installations will be required to meet relevant standards in order to be eligible.

Biogas Production Equipment – The budget proposes to further expand this list to include animal matter and sludge from a licensed sewage treatment facility, which can help stabilize the biogas production process. To ensure environmental and health standards are met, eligibility will be conditional on such inputs being disposed of in accordance with applicable federal and provincial laws. The budget also proposes to expand the eligibility criteria for equipment used to produce heat from waste sources and equipment used to produce bio-oil by removing the requirement that the industrial process, greenhouse, electrical generating facility, or cogeneration facility be operated by the taxpayer. For equipment used to produce bio-oil, eligibility will be expanded to include use of the bio-oil to produce heat for an industrial process or a greenhouse. The budget proposes to remove the requirements that biogas produced by a taxpayer’s eligible anaerobic digester system is used by the taxpayer and that it be used to produce heat for use in an industrial process or a greenhouse or to produce electricity.

Changes to Section 116 for Treaty-Protected Properties

Under Section 116, where taxable Canadian property (“TCP”) is disposed of by a non-resident, the purchaser must withhold a portion of the amount paid and remit it to the Government unless the non-resident vendor obtains a clearance certificate. The current rules do not take into account treaty-protected property and the effects of the treaty. Changes have been proposed in respect of dispositions after 2008, as noted below.

Exemption from Withholding - The budget proposes to exempt purchasers of TCP from the withholding requirements if the property is, at the time of its disposition, a treaty-protected property. If the disposition is between related persons, the purchaser must send to the Canada Revenue Agency (CRA), on or before the day that is 30 days after the date of the disposition, a notice setting out basic information about the transaction and the vendor.

“Reasonable Inquiry” Protection – The budget proposes to expand the scope of the existing “reasonable inquiry” protection for purchasers of TCP from non-resident vendors. The purchasers of TCP are not required to withhold tax from a non-resident vendor if:

- the purchaser concludes after reasonable inquiry that the vendor is, under a tax treaty that Canada has with a particular country, resident in that country;
- the property would be treaty-protected property of the vendor if the vendor were, under the tax treaty referred to above, resident in the particular country; and
- the purchaser sends to the CRA, on or before the day that is 30 days after the date of the acquisition, a notice setting out basic information about the transaction and the vendor.

Exemption from Filing Returns - Currently, a non-resident must file a Canadian income tax return for any taxation year in which the non-resident disposes of a TCP, even if the non-resident can claim tax treaty benefits or no Canadian income tax is actually payable.

For dispositions that take place after 2008, the budget proposes to exempt certain non-residents from filing a Canadian income tax return in respect of dispositions of TCP if the non-resident satisfies all of the following criteria:

- no tax is payable by the non-resident for the taxation year;
- the non-resident is not currently liable to pay any amounts in respect of any previous taxation year (other than an amount for which the CRA has accepted, and holds, adequate security); and
- each TCP disposed of by the non-resident in the year is either “excluded property” for section 116 purposes, or a property in respect of the disposition of which a certificate under section 116 has been issued.

Remittance of Source Deductions

For remittances of source deductions that are due on or after February 26, 2008, the budget proposes to replace the current 10% fixed penalty with a graduated penalty ranging from 3% to 10% of the amount required to be remitted. The penalty applied will depend on the lateness of the remittance. In addition, under the current rules, large remitters must make their withholdings directly to a financial institution. The government is proposing that a remittance paid directly and received by the CRA at least one full day before the due date will be considered to have been paid on time to a financial institution. This change applies to remittances due on or after February 26, 2008.

Donations of Medicines

To encourage the donation of excess inventories of medicine, the 2007 budget introduced an incentive deduction for corporations to participate in international programs for the distribution of medicines. However the measure is only available when the donee is a registered charity that has received a disbursement under a program of the Canadian International Development Agency (CIDA) and the gift is made in respect of activities of the charity outside of Canada. The budget proposes to change the definition of an eligible charity for this purpose to a registered charity that, in the opinion of the Minister of International Cooperation, meets conditions prescribed by regulation. (In the event that no such Minister has been appointed, the opinion will be required of the Minister responsible for CIDA.) These changes will apply to eligible donations of medicines on or after July 1, 2008.

SIFT Tax: Provincial Component

The budget proposes that for the 2009 and subsequent taxation years of “Specified Investment Flow-Through” trusts and partnerships (SIFT), the provincial component of the SIFT tax (and thus the provincial share of the resulting revenue) be based on the general provincial corporate income tax rate in each province in which the SIFT has a permanent establishment. This will ensure that the rate of the SIFT Tax is the same as the federal-provincial tax rate for large public corporations with the same activities.

Private Foundations: Excess Corporate Holdings

The 2007 budget introduced a capital gains exemption for donations of publicly listed securities to private charitable foundations. To limit potential opportunities for persons connected with a private foundation to use the shareholdings to their benefit, an excess corporate holdings regime was introduced for both publicly listed and unlisted shares. The budget proposes certain changes to these rules.

Goods and Services Tax Measures

GST Changes

Training for Individuals with Autism or Other Disabilities - Specially-designed training to help individuals cope with the effects of a disorder or disability made after February 26, 2008 will be exempt subject to certain conditions.

Nursing Services – The budget proposes that effective February 26, 2008:

- Nursing services rendered to an individual by a registered nurse, a registered nursing assistant, a licensed or registered practical nurse or a registered psychiatric nurse if the service is provided within a nurse-patient relationship, regardless of where the service is performed, will be exempt from GST.
- The exemption for diagnostic services will be expanded to include blood tests and X-rays, ordered by registered nurses.

Prescription Drugs - The budget proposes to zero-rate all supplies to final consumers of drugs prescribed by health professionals who are authorized to prescribe them under provincial or territorial legislation. This will apply to supplies made after February 26, 2008 and supplies made on or before February 26, 2008 if GST was neither charged nor collected.

Medical and Assistive Devices - The following expansion of zero-rated devices takes effect for supplies made after February 26, 2008:

- Devices for use by an individual with a severe mobility impairment or paralysis when supplied on the written order of a medical practitioner;
- Chairs designed for use by an individual with a disability, when supplied on the written order of a medical practitioner;
- Chest wall oscillation systems for use in airway clearance therapy; and
- Service animals specially trained to assist an individual with a disability or impairment that is supplied to or by an organization that is operated for the purpose of supplying such specially-trained animals.

Exempt Health Services Supplied Through a Corporation - Currently there are situations where health care services provided by a corporation are taxable but would be exempt if the same services were provided by a health professional. The budget proposes to treat these services as GST exempt regardless of whether the services are supplied directly by the health professional or through a corporation. The proposed change will apply to supplies made after February 26, 2008.

Long-Term Residential Care Facilities - Under current law, it is not clear if long-term residential care facilities, offering a high level of health or personal care, qualify for the GST New Residential Rental Property Rebate. The budget clarifies that the rebate will apply, where the units are occupied as a place of residence effective after February 26, 2008. The measure will apply for past transactions where tax has been paid on the purchase of the facility or on self-assessment where the facility was constructed or substantially renovated by the owner. An election will be allowed to have the rebate to apply on past transactions where GST was not self-assessed. The budget also proposes clarification of exempting provisions to ensure that “head lease” payments by an operator to an owner of a long-term residential care facility are exempt subject to certain conditions. “Head lease” transactions that were treated by an owner as exempt will be covered by this exemption as well as supplies after February 26, 2008.

Property Leases for Wind and Solar Power Equipment - A right to explore for certain mineral deposits is deemed to not be a supply. The budget proposes to expand this treatment for a right of entry or use to generate or evaluate the feasibility of generating electricity from the sun or wind.

Tobacco Taxation - The budget proposes a number of changes to enhance tobacco taxation enforcement and compliance, and minor changes to the duty on certain tobacco products.

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