

FEDERAL BUDGET 2007

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Mr. Flaherty's twist on the long-held tradition to buy new footwear on the eve of a new budget made me pause. Was the purchase of hockey skates meant as a complicated metaphor? Once I read through the Budget, and started to understand the impact of the international tax measures announced, I thought that perhaps the Minister's purchase of hockey skates was a warning of the deep-freeze coming our way on cross-border investments. That aside, the Budget threw tidbits here and there, although the hoped-for capital gains relief was limited to certain sectors of the population and no change of heart was apparent for income trust tax treatment.

INTERNATIONAL TAX MEASURES

International Tax "Fairness" Initiative

Under the guise of the "fairness" initiative, the Minister shocked tax practitioners nationwide with the announcement that it will be restricting the deductibility of interest paid on debt used to invest in foreign affiliates. The impact of this restriction will be felt by a larger segment of the corporate population than Finance seems to have imagined. The backlash from multinationals, banks and insurance companies has been immediate. The CRA also announced that it would be redefining the concept of the active business income of a foreign affiliate. A more detailed discussion of the impact resulting from these proposals to the foreign affiliate regime can be found in David Louis' article to be published in the next *Tax Topics* by CCH.

The proposed *International Tax Fairness Initiative* also aims to:

- o enhance Canada's ability to collect tax information from other jurisdictions, through revised tax treaties and Tax Information Exchange Agreements with non-treaty countries;

- modify the tax exemption for foreign-source active business income to also include income earned in a non-treaty jurisdiction which is party to a tax information exchange agreement with Canada; and
- provide additional funding for auditing and enforcement by the CRA.

Canada-U.S. Tax Treaty: Elimination of Withholding Tax on Interest

Happily for those paying interest across the border, Budget 2007 announced that Canada and the United States have agreed in principle to update the Canada-U.S. Tax Treaty and to provide that cross-border interest payments will no longer be subject to withholding tax (currently set at 10%) by the source country (the country where the payor resides). The tax for arm's length interest payments will be eliminated effective on the first year following the coming into force of the treaty. For non-arm's length interest, payments will be phased-in over three years (7%, 4% & 0%) effective also on the first year following the coming into force of the treaty.

It was also proposed that once the Canada-U.S. Tax Treaty becomes effective, Canadian withholding tax will be eliminated on interest paid to all arm's length non-residents, regardless of their country of residence.

CORPORATE TAX MEASURES

Capital Cost Allowance

Focusing on the various factors affecting the shelf-life of an asset (i.e. changing technology and market conditions). Budget 2007 proposes several adjustments to improve the CCA system, including the following:

Asset	Current Rate	New Rate
Buildings used for manufacturing or processing	4%	10%
Other non-residential buildings	4%	6%
Computer equipment	45%	55%
Natural gas distribution lines	4%	6%
Liquefied natural gas facilities	4%	8%

A temporary incentive was announced for manufacturing and processing machinery and equipment (otherwise included in Class 43) such that the CCA rate will be accelerated to 50% (subject to a half-year rule so that the assets can be written off on average over a two year period). This applies to assets acquired after March 19, 2007 and prior to 2009. Why the boost to M&P? Apparently government has been subject to some serious lobbying from the Canadian Manufacturers and Exporters.

And to try to enhance the government’s reputation in the environmental realm, the Budget 2007 proposes to expand the list of eligible equipment under Class 43.2, which provides for a 50% accelerated CCA for specified energy generation equipment that:

- o uses a renewable energy source;
- o uses waste fuel; or
- o makes efficient use of fossil fuels.

This Class will be expanded to include wave and tidal energy and a broader range of applications involving active solar heating, photovoltaics, stationary fuel cells, pulp and paper waste fuels and production of biogas from organic waste. Budget 2007 also proposes to extend eligibility for Class 43.2 to assets acquired before 2020.

Investment Tax Credit for Child Care Spaces

A new tax credit was introduced and aimed at businesses who take the step to create licensed child care spaces for the children of their employees and, potentially, for children in the surrounding community. The non-refundable investment tax credit will be available to

eligible businesses (i.e. taxpayers who carry on a business in Canada) that create one or more new child care spaces in a new or existing licensed child care facility and will be equal to 25% of eligible expenditures, to a maximum credit of \$10,000 per child care space created. The provision of child care spaces must be ancillary to one or more businesses of the taxpayer that do not include the provision of such spaces.

Eligible expenditures will include the cost of certain depreciable property and certain start-up costs. The credit will not be available for any ongoing or operating expenses (i.e. supplies, wages, utilities, etc.). Unused credits may be carried back 3 years and forward 20 years.

**Making the World a Better Place:
Donation of Medicines for the Developing World**

As a further incentive to encourage participation in international programs for the distribution of medicines, Budget 2007 proposes to allow corporations that make donations of medicines from their inventory to claim a special additional deduction equal to the lesser of the cost of the donated medicine and 50% of the amount, if any, by which the fair market value of the donated medicine exceeds its cost.

The donee must be a registered charity that has received a disbursement through the Canadian International Development Agency and the gift must be used for activities outside of Canada. This measure will apply to gifts made on or after March 19, 2007.

PERSONAL INCOME TAX MEASURES

Lifetime Capital Gains Exemption

Under the current tax regime, an individual is allowed a lifetime capital gains exemption (LCGE) on up to \$500,000 of capital gains realized on the disposition of qualified farm and fishing property or qualified small business corporation shares. Budget 2007 proposes to increase the LCGE such that it will apply to up to \$750,000 of capital gains realized by an individual on qualified properties. This measure will apply to dispositions of property that

involving more than \$100,000 worth of shares of a particular class or more than 0.5% of all outstanding shares of that class.

- “Divestment Required” – if a foundation and all non-arm’s length persons together hold more than 20% of all outstanding shares in any one class of shares, a divestment will be required and the foundation will be subject to penalties unless the combined holdings are reduced to 20% or less within specified time periods, or until the holdings of the foundation do not exceed 2%.

Working Income Tax Benefit

Budget 2007 proposes to introduce the Working Income Tax Benefit (WITB) which will provide a refundable tax credit equal to 20% of each dollar of “earned income” in excess of \$3,000 to a maximum credit of \$500 for single individuals without dependants and \$1,000 for families. “Earned income” means the total amount of an individual’s or family’s income for the year from employment and business (without reference to any losses).

However, as this incentive is targeted to low-income taxpayers, the credit will be reduced by 15% of “net family income” in excess of \$9,500 for single individuals and \$14,500 for families. Net family income will be calculated on the same basis as is currently used for the purpose of the Canada Child Tax Benefit and the goods and services tax credit (i.e.: total income minus the Universal Child Care Benefit and any allowable deductions such as pension contributions and child care expenses).

Registered Disability Savings Plan

A new Registered Disability Savings Plan (RDSP) was announced along with a Canada Disability Savings Grant (CDSG) program and Canada Disability Savings Bond (CDSB) program. A taxpayer (or legal representative) can establish an RDSP if he or she is eligible for the disability tax credit and is a resident in Canada. These requirements must be met when the plan is established and whenever a contribution is made to the plan or a CDSG or CDSB is paid to the plan.

Similar to an RESP, contributions to an RDSP will not be deductible; however, investment income earned in the plan will accrue tax-free. Investment income earned in the plan will be

included in the beneficiary's income when paid out of an RDSP. Contributions to an RDSP will be limited to a lifetime maximum of \$200,000, with no annual limit. There will be no restriction on who can contribute to the plan. Contributions will be permitted until the end of the year in which the beneficiary attains 59 years of age.

Changing the Contribution and CESG Limits

Budget 2007 proposes the following changes:

- The \$4,000 annual RESP contribution limit will be eliminated and the lifetime RESP contribution limit will be increased to \$50,000 from \$42,000.
- The maximum annual RESP contribution qualifying for the 20% CESG will be increased to \$2,500 from \$2,000, thus increasing the maximum CESG per beneficiary for 2007 and subsequent years to \$500 from \$400. The maximum CESG for a year will increase to \$1,000 from \$800 if there is unused grant room because of contributions of less than the maximum CESG-eligible contributions for previous years. The \$7,200 lifetime CESG limit will be unaffected by this change.

While these changes will apply to contributions made after 2006, taxpayers will have to wait until Royal Assent for CESG entitlements that are attributable exclusively to the increased CESG limit.

Note: If only one lump-sum payment of \$50,000 is made, be aware that you will be limited to \$500 from the government for the year you make the payment (unless you have unused grant room from previous years) and you won't get any more grant money for future years. So think carefully before you make a one-time lump-sum payment as you may be giving up a chunk of grant money.

Extending RESP Eligibility to More Part-Time Studies

Education Assistance Payments (EAP) are currently limited to full-time students and to part-time students with a heavy course load. Budget 2007 proposes to relax the EAP eligibility requirement to accommodate students 16 years of age or older who will now be able to receive up to \$2,500 of EAPs for each 13-week semester of part-time study. This change applies to the 2007 and subsequent taxation years.

Elementary and Secondary School Scholarships

Scholarships and bursaries that are provided to attend elementary and secondary schools will be fully exempted from income (currently any amounts in excess of \$500 are included in computing income).

New Child Tax Credit

Budget 2007 proposes to introduce a new non-refundable child tax credit for parents based on an amount of \$2,000 (indexed) for each child under the age of 18 years at the end of a taxation year. The tax credit will be calculated by reference to the lowest personal income tax rate for the taxation year (i.e.: 15.5% for 2007). This new tax credit will take effect beginning in 2007 and will result in personal income tax relief of up to \$310 per child. The claim is to be made by the parent upon whom the child is wholly dependent (or by either parent if the child resides with both parents). Any unused portion of the credit will be transferable by a parent to a spouse or common-law partner.

Spousal and Other Amounts

Currently for 2007, the basic personal amount credit is \$8,929 for 2007 whereas the credit in respect of a spouse or common-law partner (or a wholly dependent relative) is \$7,581 for 2007 (the latter amount is reduced on a dollar-for-dollar basis by the dependant's net income in excess of a threshold (\$759 for 2007)).

Budget 2007 proposes to increase the spouse or common-law partner and wholly dependent relative credit by \$1,348 to match the basic personal amount, with a corresponding elimination of the threshold above which the dependant's net income must be taken into account. These changes will take effect beginning in 2007 and will provide tax relief of up to \$209. For the 2008 and subsequent taxation years, these personal credit amounts will be increased by the same amounts that are currently legislated for the basic personal amount.

to expire in March 2007). Under the 'look-back' rule, funds raised with the benefit of the credit in 2008, for example, can be spent on eligible exploration up to the end of 2009.

ADMINISTRATIVE MEASURES

Increasing Installment Thresholds

The Budget 2007 proposes to increase the installment thresholds across the board:

Corporate Income Tax: The installment threshold has been proposed to be tripled to \$3,000 from \$1,000. The frequency of installment payments will be reduced from monthly to quarterly for small and medium-sized businesses that meet certain thresholds. Quarterly installments will be available for corporate taxation years that begin after 2007. The balance-due day for the final payment of corporate tax for a taxation year will remain unchanged.

Personal Income Tax: The installment threshold for self-employed individuals or seniors will be increased from \$2,000 to \$3,000 (\$1,800 for individuals resident in Quebec, increasing from \$1,200). The balance of the taxes payable for a taxation year will continue to be due on April 30 of the following taxation year. These changes to the installment threshold amounts will apply to the 2008 and subsequent taxation years.

Source Deductions: This threshold amount is tripled to \$3,000 from \$1,000. These changes will apply to calendar years beginning with 2008.

GST/HST: The taxable supplies threshold to file GST/HST returns annually is to be tripled to \$1,500,000 from \$500,000. Additionally, the Budget proposes to double the net tax threshold, below which annual GST/HST filers can make one tax remittance, to \$3,000 from \$1,500.

These measures will apply to fiscal years that begin after 2007.

100 kilometres, and range from \$1,000 to \$4,000. The Green Levy will be imposed under the *Excise Tax Act* (ETA) and will be payable by the manufacturer or importer at the time vehicles are delivered to a purchaser (usually a dealer) or imported.

Removal of Excise Tax Exemption for Renewable Fuels

Under the *Excise Tax Act*, renewable fuels are currently exempt from the federal excise taxes of 10-cents-per-litre on gasoline and 4-cents-per-litre on diesel fuel that would otherwise apply to their use as motive fuels. However, the government has announced a series of measures to encourage renewable fuels which are to provide a more significant incentive than excise tax exemptions. Accordingly, Budget 2007 proposes to repeal the excise tax exemptions for renewable fuels, including biodiesel and alcohol-based fuels, and to ensure that renewable fuels are included within the excise tax structure that applies to gasoline and diesel fuel. These measures will apply to fuel delivered on or after April 1, 2008.

OTHER MEASURES

Single Administration of Ontario Corporate Tax

The Budget provided for payments to Ontario totaling \$400 million to ensure a smooth transition to a single corporate tax administration as between the federal and Ontario government, all in accordance with the Memorandum of Agreement signed in October of 2006. The Agreement provides for the collection and administration of Ontario's corporate tax by the federal government for taxation years that end after 2008.

Payment of Provincial Sales Taxes by Crown Corporations

Budget 2007 proposes to make appropriate amendments to clarify that, where the requirement to pay provincial taxes and fees applies to a federal Crown corporation, it will also apply to the corporation's wholly-owned subsidiaries. The proposed amendment will apply from July 1, 2000, in order to cover the application period of all reciprocal tax agreements currently in place.

