



2008 Federal Budget Commentary

"Responsible Leadership for Uncertain Times"

February 26, 2008

Introduction

Today, the Honourable Jim Flaherty, Minister of Finance, tabled the Conservative government's third Federal Budget implementing their economic plan, Advantage Canada, in the hopes of enhancing Canada's long term prosperity. The focus of the budget is to reduce debt and taxes, focus on government spending, and provide support for struggling sectors of the economy in uncertain times.

The key initiatives for budget 2008 are as follows:

- **Maintaining strong fiscal management** and continuing to reduce debt. Planned debt reduction for 2007–2008 is \$10.2 billion and a total of \$13.8 billion over the two year budget-planning period.
- **Carefully managing spending** to ensure programs and services are efficient, effective, aligned with the priorities of Canadians, and affordable over the long term.
- **Strengthening Canada's Tax Advantage** with a new Tax Free Savings Account to promote savings; extend support to the manufacturing sector and supporting small/medium sized business by improving the scientific research and experimental development tax incentive program.
- **Investing in the future** by enhancing financial support for students, providing flexibility of RESPs, establishing new scholarships and awards, and increasing support for research in science and technology.
- **Supporting communities** that are vulnerable to economic adjustments in global markets with \$250 million for an Automotive Innovation Fund to help Canada's automotive sector, and additional funds allocated to the forestry sector, farm programs and the aquaculture industry. The budget makes the Gas Tax Fund a permanent measure, and establishes a new crown corporation PPP Canada Inc. to work with public-private partnerships.
- **Providing leadership at home** by supporting the vulnerable, protecting the health and safety of Canadians, strengthening partnerships with Aboriginal Canadians, protecting Canada's sovereignty in the Arctic, ensuring a cleaner, healthier environment, and tackling crime and bolstering security by providing \$400 million to hire 2,500 new police officers over 5 years.
- **Providing leadership abroad** by providing the Canadian Forces with stable and predictable funding to permit long-term planning; delivering on Canada's promises for international assistance (including a commitment to rebuild a free and democratic Afghanistan); promoting Canada's trade and investment interests around the world; and improving the security and efficiency of our borders.

Overall, the government's fiscal position remains strong, with planned continued surpluses, planned debt reductions and a declining federal tax burden (measured by the total tax revenues as a share of the economy) of 15.3% – the lowest level in nearly 50 years.

Personal Tax Measures

Tax Free Savings Account (TFSA)

The government introduces what they describe to be the single most important personal savings vehicle since the Registered Retirement Savings Plan (RRSP). The TFSA will allow Canadians aged 18 or older to save up to \$5,000 (indexed for inflation) every year starting in 2009 for “everything else in life”.

Contributions to the TFSA will not be deductible for income tax purposes, but investment income including capital gains earned in the TFSA will not be taxed, even when withdrawn. TFSA contribution room can be carried forward to future years, and funds can be withdrawn at any time for any purpose. Amounts withdrawn can be put back in the TFSA at a later date, without reducing your contribution room. Neither income earned nor withdrawals affect your eligibility for federal income tested benefits or credits, such as the Canada Child Tax Benefit, GST Credit, Old Age Security, or Employment Insurance Benefits. Interest on money borrowed to invest in a TFSA is not deductible.

The TFSA will be permitted to hold the same investments as an RRSP, however will be prohibited from holding investments in any entities with which the account holder does not deal at arm’s length. TFSA assets can be used as collateral for loans. Excess contributions will be subject to a 1% per month penalty. Similar to RRSPs, an individual’s TFSA can be transferred to his or her spouse on death, maintaining its tax exempt status.

Dividend Tax Credit (DTC)

The current dividend gross up factor of 45% and the existing DTC rate of 19% for eligible dividends will be adjusted to reflect the corporate income tax rate reductions in the 2007 Economic Statement.

| | 2008 | 2009 | 2010 | 2011 | 2012 |
|-----------------|------|------|------|-------|------|
| Proposed | | | | | |
| Enhanced DTC | 19% | 19% | 18% | 16.5% | 15% |
| Gross Up | 45% | 45% | 44% | 41% | 38% |

Registered Education Savings Plans (RESPs)

RESPs are tax assisted savings vehicles designed to help families accumulate savings for the post-secondary education of their children. The existing limits for RESPs will be increased by an additional 10 years. Contributions to an RESP can be made for 31 years (currently 21 years) following the year in which the plan is generally entered into, and must be terminated by the end of the year that includes the 35th anniversary (currently 25th) of the opening of the plan. No contributions may be made to a family plan for a beneficiary who is 31 (currently 21) years of age or older. These changes apply for the 2008 and subsequent taxation years.

Additionally, RESP beneficiaries will be allowed to receive education assistance payments from the plan for up to six months after ceasing to be enrolled in a qualifying program, for 2008 and later years.

Medical Expense Tax Credit

Effective for 2008 and subsequent taxation years, the budget proposes to add to the list of expenses eligible for the medical expense tax credit: the cost to purchase, operate and maintain the following devices prescribed by a medical practitioner:

- altered auditory feedback devised for the treatment of a speech disorder;

- electrotherapy devised for the treatment of a medical condition or a 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.

Eligible expenses for service animals specially trained to assist individuals with autism or epilepsy will be recognized. The expenses include the cost, care and maintenance of the service animal, as well as reasonable travel expenses incurred for the individual to attend a school, institution or other place that trains the individual in the handling of such an animal.

Legislation is also proposed to clarify the definition of eligible drugs and medications, to ensure that those purchased without a prescription remain ineligible.

Registered Disability Savings Plan (RDSP)

The RDSP rules that provide for a mandatory collapse of a plan if the beneficiary ceases to be eligible for the Disability Tax Credit (DTC), will be amended to provide a mandatory collapse only where the beneficiary's condition has factually improved to the extent that the beneficiary no longer qualifies for the DTC instead of if the beneficiary chooses to rescind their disability tax credit certification.

Capital Gains and Donations: Exchangeable Securities

The existing capital gains tax exemption for donations of publicly traded securities will be extended to capital gains realized on the exchange of unlisted securities that are shares or partnership interests for publicly traded securities for donations made on or after February 26, 2008.

Private Foundations

Budget 2007 introduced an excess corporate holdings regime for private foundations, which limits the foundation's ownership of certain shares. The budget proposes to provide foundations with relief in respect of unlisted shares held on March 18, 2007 – making these shares exempt and not required to be disposed. However it also proposes to attribute to a foundation, shares held by a trust on March 18, 2007, deeming the foundation to own shares held by a trust, in proportion to its interest in the trust. Anti-avoidance provisions were tabled to address attempts to circumvent the rules above.

Other Personal Tax Measures

The Northern Residents deduction will be increased by 10%, increasing the maximum deductions to \$8.25 per day (from \$7.50) for each member of a household, for taxpayers with a basic residency deduction and \$16.50 per day (from \$15.00) for one member of a household, if no other member claims the basic amount.

The eligibility for the mineral exploration tax credit which was scheduled to expire March 31, 2008 will be extended to flow through share agreements entered into on or before March 31, 2009.

Business Income Tax Measures

Scientific Research and Experimental Development Program (SR&ED)

Current System

Under the current rules, certain Canadian controlled private corporations (CCPCs) carrying out research activities in Canada are eligible to receive enhanced tax credits on eligible scientific research and experimental development (SR&ED) expenditures. All corporations are eligible for a 20% non-refundable tax credit on eligible SR&ED expenditures. Certain CCPC's are eligible to receive a 35%

(20% for all corporations plus an additional 15%) refundable tax credit on SR&ED expenditures up to \$2 million.

Current rules phase-out the enhanced SR&ED credits available to CCPCs if the prior year income of the corporation exceeds the corporation's small business limit. The phase-out mechanism reduces the corporations SR&ED expenditure limit by \$10 for each \$1 of income exceeding the corporation's small business limit in the prior year.

The current SR&ED program reduces the enhanced refundable 35% tax credits available to CCPCs for corporations with taxable capital exceeding \$10 million with a total elimination of the enhanced tax credits for corporations exceeding \$15 million in taxable capital.

Proposed Changes

The budget proposes several enhancements to the existing SR&ED program including:

- An increase of the SR&ED expenditure limit from \$2 million to \$3 million;
- An increase in the upper limit of the phase-out range for prior year taxable income from \$600,000 to \$700,000; and
- An increase in the upper limit of the taxable capital phase-out range from \$15 million to \$50 million.

The current rules and proposed changes to the SR&ED thresholds are summarized as follows:

| | Current System | Proposed System |
|-------------------|-------------------------------|-------------------------------|
| Expenditure Limit | \$ 2 million | \$ 3 million |
| Taxable Income | | |
| • phase out range | \$ 400,000 - \$ 600,000 | \$ 400,000 - \$ 700,000 |
| Taxable Capital | | |
| • phase out range | \$ 10 million - \$ 15 million | \$ 10 million - \$ 50 million |

The maximum fully refundable ITC's earned with the proposed \$3 million expenditure limit for CCPCs at various levels of taxable income and taxable capital may be summarized as follows:

| | | Taxable Income | | | |
|-------------------------------|-------|----------------|------------|------------|------------|
| | | \$ 400,000 | \$ 500,000 | \$ 600,000 | \$ 700,000 |
| Taxable Capital (millions) | \$ 10 | \$ 1,050,000 | \$ 700,000 | \$ 350,000 | - |
| | \$ 20 | \$ 787,500 | \$ 525,000 | \$ 262,500 | - |
| | \$ 30 | \$ 525,000 | \$ 350,000 | \$ 175,000 | - |
| | \$ 40 | \$ 262,500 | \$ 175,000 | \$ 87,500 | - |
| | \$ 50 | - | - | - | - |

Other SR&ED program changes

In addition to the above changes, the budget proposes to ease restrictions on expenditure eligibility for certain SR&ED activities carried on outside Canada. Certain salary or wages incurred by a taxpayer in respect of SR&ED carried on outside of Canada may now be eligible for tax credits within certain limits.

Changes to the SR&ED program apply to taxation years ending on or after February 26, 2008 and may be prorated for the number of days after February 25, 2008.

Accelerated Capital Cost Allowance (CCA) for Manufacturing and Processing

Manufacturing and Processing companies claiming capital cost allowance under the Class 43 Manufacturing and Processing CCA rate of 30% will qualify for the following accelerated CCA rates for assets purchased in the calendar years 2009 through 2011:

- The 50% straight line CCA treatment has been extended for assets acquired in the 2009 calendar year;
- Assets acquired in 2010 will be eligible for CCA at a 50% declining balance in the year of acquisition, a 40% declining balance in the second year of asset ownership and a 30% declining balance thereafter; and
- Assets acquired in 2011 will be eligible for CCA at a 40% declining balance in the year of acquisition and a 30% declining balance rate thereafter.

The “half-year” rule will apply to asset additions which limits the deduction for capital cost allowance in the year of acquisition. Assets purchased in the calendar years 2010 and 2011 will be included in a separate class 43 until the special CCA rates expire and the remaining capital cost balances are included with other Class 43 assets.

Accelerated CCA for Clean Energy Generation

The budget proposes enhanced CCA rates for:

- Clean Energy Generation equipment;
- Ground Source Heat Pump Systems;
- Biogas Production Equipment; and
- Waste-To-Energy Applications.

As well, the budget proposes to align the CCA rates with the useful life of:

- Railway Locomotives – increasing CCA rates from 15% to 30%; and
- Carbon Dioxide Pipelines and Related Equipment – increasing CCA rates from 4% to 8%.

SIFT Tax: Provincial Component

“Specified Investment Flow Through” trusts and partnerships (SIFTs) – publicly traded income trusts (including business and energy trusts) and partnerships are subject to a tax on their distributions. For 2009 and subsequent taxation years the provincial component of the SIFT tax will be based on the general provincial corporate income tax rate in each province in which the SIFT has a permanent establishment, to ensure the rate of SIFT tax is the same as for large public corporations with the same activities.

International Tax Measures

Cross Border Business and Investment

The budget proposes to ease the compliance burden and non-resident tax withholding requirements for non-residents who dispose of taxable Canadian property and are exempt from Canadian taxation under an international tax treaty. The proposed changes may exempt non-residents from personal tax filings, compliance filings and non-resident tax withholdings required under current legislation.

These measures will apply in respect of dispositions that take place after 2008.

GST and Excise Tax Measures

Exempt Health Services Supplied Through a Corporation

Services of health professions will be treated as GST/HST exempt regardless of whether their services are supplied directly by the health professional or through a corporation, for supplies made after February 26, 2008.

Nursing Services

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 will be exempt from GST/HST, regardless of where the service is performed (i.e. hospital or private institution). The exemption for diagnostic services that are prescribed by regulation, such as blood tests and X-rays, will be expanded to include those ordered by registered nurses.

Training for Individuals with Autism or Other Disabilities

The exemptions for basic health and education services for individuals with autism or other disabilities will be expanded to include training that is specially designed to assist individuals to cope with the effects of a disorder or disability if certain criteria are met. This exemption will apply for supplies made after February 26, 2008.

Prescription Drugs

All supplies to final consumers of drugs prescribed by health professionals who are authorized to prescribe them under provincial or territorial legislation will be zero-rated, after February 26, 2008.

Medical and Assistive Devices

The list for zero rated medical and assistive devices made after February 26, 2008 was expanded to be consistent with the changes made to the medical expense tax credit.

Long Term Residential Care Facilities

The GST New Residential Rental Property Rebate and GST/HST exempt treatment will apply to long term residential care facilities on a going forward basis, and may also apply to past transactions where the owner has paid tax on the facility or elects to have the new rules apply.

Property Leases for Wind and Solar Power Equipment

The budget proposes relief from GST/HST in certain circumstances to be expanded to include the supply of a right of entry or use to generate, or evaluate the feasibility of generating, electricity from the sun or wind. The proposal will apply for supplies made on or after February 26, 2008.

Tobacco and Other Excise Taxes

A number of changes were implemented to enhance tobacco taxation enforcement and compliance, and minor changes to the duty on certain tobacco products.

The budget proposes changes to the alcohol excise taxation system to require imitation spirits to be rated like its competition, spirits rather than beer.

Administrative and Other Tax Measures

Remittance of Source Deductions

The 2003 pilot project for a graduated penalty regime will be enacted for remittances that are due on or after February 26, 2008.

- 3% penalty if 1 - 3 days late
- 5% penalty if 4 - 5 days late
- 7% penalty if 6 - 7 days late
- 10% penalty if more than 7 days late

Large remitters who remit to CRA at least one day before the due date will be considered to be in compliance with the requirement that it be remitted to a financial institution, for remittances after the budget date.

Business Number Initiative

As part of the initiative to reduce the paper burden on small business, legislation will be developed with consultations with the Office of the Privacy Commissioner, to allow business number (BN) related information to be shared with other government entities, including other levels of government in Canada.

Aboriginal Tax Policy

The government reiterates its willingness to discuss and put into effect direct taxation arrangements with interested self-governing Aboriginal groups.

Disclaimer

The information contained herein is for information purposes only and is not intended to be complete in all respects. It is a summary of budget materials released by the Department of Finance Canada. It is not certain if all or parts of these materials will become law. We recommend that you consult with a Collins Barrow tax professional before acting on the basis of material contained herein.