2007 Federal Budget

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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:*

- 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:

- uses a renewable energy source;
- uses waste fuel; or
- 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 occur on or after March 19, 2007. The Budget proposed a formula to deal with an LCGE claim for the 2007 taxation year where both limits are at play.

If an individual has already used up the $500,000 LCGE, query whether he or she should take further steps to crystallize the extra $250,000. If so, one would have to ensure that the shares or property still qualify under the LCGE rules and whether taking steps to “purify” the shares or property would be worthwhile for the extra tax savings. If one has not used up their LCGE, query whether there would be increased clawbacks (i.e.: Old Age Security or cumulative net investment loss balances) to match the increase in the LCGE. Also, be aware of the alternative minimum tax that can hit you as a result of the increased LCGE.

Eliminating Capital Gains Tax on Charitable Donations to Private Foundations

Currently, charitable donations of publicly-listed securities to public charities are exempt from capital gains tax. Budget 2007 proposes to extend this tax-free treatment to donations of publicly-listed securities to private foundations. Moreover, an arm’s length employee who acquires a publicly-listed security under an option granted by the employer and donates the security to a private foundation within 30 days, may be eligible for a special deduction such that the employee may avoid the associated taxable benefit (currently available for donations to public charities). These measures will apply to gifts made on or after March 19, 2007.

However, in order to avoid “self-dealing” situations, Budget 2007 proposes to introduce an excess business holdings regime for private foundations to place limits on foundation shareholdings:

- “Safe Harbour” – If a foundation holds 2% or less of all outstanding shares of any one class of shares of a corporation, the foundation will be not subject to any monitoring.
- “Monitoring Phase” – If a foundation holds more than 2% of the share noted above, it will be subject to monitoring by the CRA and must report any material transactions during the year by the foundation or non-arm’s length persons (i.e.: transactions 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 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.

Public Transit Tax Credit

Budget 2007 proposes to extend the non-refundable public transit tax credit for the cost of monthly public transit to accommodate electronic payment cards (which allow for 32 one-way trips to be used in 31 days) and weekly passes (provided that four consecutive weekly passes are purchased). Individuals making claims will be required to retain their receipts or passes for verification purposes. This measure will apply to electronic payment cards issued after 2006 and weekly passes valid for use after 2006.

Meal Expenses of Truck Drivers

Budget 2007 proposes to increase, over five years, to 80% from 50% the deductible portion of the cost of food and beverages consumed by long-haul truck drivers during eligible periods of travel. This measure will also apply to employers that pay, or reimburse, such costs incurred by long-haul truck drivers that they employ.

A long-haul truck driver includes both an employee whose principal duty of employment is to drive long-haul trucks for the purpose of transporting goods and an individual whose principal business is to drive long-haul trucks for the purpose of transporting goods.

Phased Retirement

Budget 2007 proposes to allow employees who are at least 55 years of age and older to draw a limited pension benefit (up to 60%) while continuing to work and accrue new pension benefits. In addition, the employee must be eligible to receive a pension without the plan imposing an early retirement reduction.

Age Limit for Maturing RPPs and RRSPs

Budget 2007 proposes to push back the age limit upon which RPPs and RRSPs will be required to be converted from 69 years of age to 71 years of age (and will benefit those who turn 69 years of age in 2007 or in a subsequent year). If an individual turns 70 or 71 years of age in 2007 (or in a subsequent year), they will be allowed to continue to contribute to their RRSP assuming contribution room is available. In addition, the requirement that a specified minimum amount be withdrawn from a RRIF each year after the RRIF is established will be waived if an individual meets the above age limits for 2007 onwards.

A RRIF annuitant who is 71 years of age or younger at the end of 2007 will be able to reconvert their RRIF to an RRSP, so long as the re-established RRSP is converted to a RRIF before the end of the taxation year in which he or she turns 71 years of age. Existing registered plan annuities will be permitted to be amended, without adverse tax consequences, and employers will be allowed to amend their RPPs to allow benefits to accrue, and contributions to be made to reflect the change in age limit, subject to any otherwise applicable adjustments to pensions in pay.

RRSP Qualified Investments

The list of qualified investments for RRSP purposes was proposed to be extended to the following debt obligations and publicly-listed securities:

- any debt obligation that has an investment grade rating and that is part of a minimum $25 million issuance; and
- any security (other than a futures contract) that is listed on a designated stock exchange. For this purpose, a designated stock exchange will include any stock exchange that is currently identified as a prescribed stock exchange (see discussion below).

The rationale behind these inclusions is to allow investments in foreign-listed trust and partnership units and Canadian dollar bonds issued by foreign entities. These changes are effective after March 18, 2007.

Prescribed Stock Exchanges

Budget 2007 proposes to update the concept of "prescribed stock exchange" by replacing the two lists of currently prescribed stock exchanges with a new three-tier system:

- exchanges that are currently prescribed and which the Minister has designated. This category does not apply to section 116 withholding procedure and the securities lending rules.
- “Recognized Stock Exchange”: Includes stock exchanges located in Canada or another OECD country that has a tax-treaty with Canada in addition to all designated stock exchanges. This category will apply for section 116 withholding procedures.
- “Stock Exchange”: Includes any stock exchange, regardless of location, and includes all designated and recognized stock exchanges. This category will be used for the purposes of the securities lending rules.

These changes are proposed to be effective upon Royal Assent to the necessary amending legislation.

Northern Residents Deduction

The Budget proposals include a deduction for individuals who live in prescribed areas in northern Canada for at least six consecutive months beginning or ending in a taxation year. The deduction includes a residency deduction of up to $15 per day, plus a deduction to offset taxable benefits in respect of up to two employer-paid vacation trips per year and an unlimited number of employer-paid medical trips. A full deduction is available to residents who live in the prescribed “Northern Zone” (i.e.: more isolated areas) whereas residents of the “Intermediate Zone” (i.e.: not as isolated areas) are eligible for a half deduction.

The 2010 Games in Vancouver

In the spirit of the Olympic games, Budget 2007 proposed the waiving of withholding taxes on payments to non-residents associated with the Games, including payments made to the International Olympic Committee or International Paralympic Committee. Examples of exempt payments include Canadian-source income arising if a non-resident athlete were paid by a commercial sponsor based on his or her 2010 Games performance, or a foreign journalist filing a story from the 2010 Games who might be considered to be employed in Canada.

Mineral Exploration Tax Credit

Budget 2007 proposes to extend eligibility for the mineral exploration tax credit to flow-through share agreements entered into on or before March 31, 2008 (which is currently due 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.

Sales and Excise Tax Measures

Foreign Convention and Tour Incentive Program

Budget 2007 proposes a new Foreign Convention and Tour Incentive Program to replace the Visitor Rebate Program which is to be eliminated per the Government's announcement in September of 2006. This program will provide GST relief in respect of certain property and services used in the course of conventions held in Canada and the accommodation portion of tour packages for non-residents.

48-Hour Travellers' Exemption

Budget 2007 proposes to increase the travellers' exemption to $400 from $200 for returning Canadian residents who are out of the country for 48 hours or more. The dollar limits that apply to the 24-hour and 7-day duty- and tax-free exemptions will remain unchanged at $50 and $750 respectively. Volume and quantity limits on alcohol and tobacco products also remain unchanged. This measure is effective for travellers returning to Canada on or after March 20, 2007.

Exports of Intangible Personal Property

Budget 2007 confirmed the zero-rating of all supplies of intangible personal property made to non-residents who are not registered for GST/HST purposes except for certain situations, including if the supply is made to a person physically present in Canada, the supply relates to property situated in Canada or the IPP may only be used in Canada.

Green Levy on Fuel-Inefficient Vehicles

As noted above, the Government may have felt obliged to throw out a couple of climate control treats to appease their critics. Budget 2007 introduces a vehicle efficiency incentive (VEI) designed to promote the purchase of fuel-efficient vehicles in Canada. The VEI structure includes a rebate for highly fuel-efficient vehicles, neutral treatment for vehicles of average fuel efficiency and a new Green Levy on fuel-inefficient vehicles. The Green Levy is aimed at vehicles that have a weighted average fuel consumption of 13 or more litres per 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.

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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.

Provincial Capital Taxes

For those provinces who have not yet eliminated their capital taxes, Budget 2007 proposes a temporary financial incentive to them to eliminate provincial general capital taxes or capital tax on financial institutions (or restructure a currently existing capital tax on financial institutions into a minimum tax) if such elimination or restructuring takes effect on or before January 1, 2011, and the enabling legislation is enacted on or after March 19, 2007 and before 2011. Ontario is the first province to fall in line with its announcement to eliminate capital tax by 2010 per its 2007 Budget release on March 22, 2007.

Trust T3 Information Returns

Due to concerns raised with the existing due-date for the issuance of Trust T3 returns (March 31), the Budget announced that it is expected that draft regulations to give effect to a more efficient process for 2007 T3 slips will be released in the near future.

Previously Announced Measures

Budget 2007 confirms the Government's intention to proceed with the previously announced tax measures, including the Tax Fairness Plan announced on October 31, 2006 that dealt the tax hit to income trusts. This was disappointing news for those who still held their breath in hopes that Finance would ease off on income trusts.