



2007 Federal Budget Highlights

The tax highlights of the Budget include:

- increase of the Capital Gains Exemption from \$500,000 to \$750,000
- RRSP conversion to RRIF moved back to age 71
- Enhancing rules on donations of securities to private foundations
- major changes to the taxation of active business income of foreign affiliates;
- elimination of withholding tax on payments of interest under the Canada-U.S. income tax treaty and on all other arm's length interest payments;
- changes to the capital cost allowance rules, including a temporary increase in the allowances for manufacturing and processing machinery and equipment, and the elimination of accelerated allowances for oil sands projects.
- Revisions to some instalment and filing requirements to reflect inflation

Personal Income Tax Measures

Phased Retirement

Beginning in 2008, employees > 54 years old, who are eligible to receive a pension without incurring an early retirement reduction, will be able to receive pension benefits from a defined benefit Registered Pension Plan (RPP), of up to 60% of their accrued pension, while simultaneously accruing further pension benefits for current full or part-time employment service.

This new rule will not apply to the following:

- where an employee and employer are not at arm's length,
- where an employee owns 10% or more of the shares of his corporate employer (or of a related corporation), and
- to Individual Pension Plans (IPP's).

Age Limit for Maturing RPPs and RRSPs

The annuitant's age of maturity will increase from 69 to 71 for Registered Pension Plans (RPPs, Deferred Profit Sharing Plans (DPSP's) and Registered Retirement Savings Plans (RRSPs) beginning with the 2007 calendar year. Transitional rules will enable individuals who turn 70 or 71 in 2007 to take advantage of this new rule.

Minimum annual withdrawals from a Registered Retirement Income Fund (RRIF) will be waived for 2007 + 2008 for annuitants who turn 70 in 2007 - and waived for 2007 for annuitants who turn 71 in 2007. A RRIF annuitant who is < 72 at the end of 2007 will be able to reconvert the RRIF to an RRSP, as long as this RRSP is converted back into a RRIF before the end of the year in which the annuitant turns 71.

Existing registered plan annuities will be permitted to be amended to reflect the later conversion age. Employers will also be allowed to amend their RPPs to allow benefits to accrue and contributions to be made in respect of employees who are < 72 at the end of 2007.

RRSP Qualified Investments

The list of qualified investments for RRSPs and other registered plans will be expanded after March 18, 2007 to include:

- 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, listed on a designated stock exchange.

Registered Education Savings Plans (RESPs)

- the maximum annual contribution is eliminated
- increase of the lifetime limit from \$42,000 to \$50,000
- increase of the maximum annual RESP contribution qualifying for the 20% Canada Education Savings Grant (CESG) from \$2,000 to \$2,500 for 2007 and subsequent years.
- the lifetime CESG limit of \$7,200 will remain as is.

Beginning in 2007, a relaxation of the Educational Assistance Payments (EAPs) rules to accommodate students enrolling in part-time courses requiring at least 12 hours per month of study. This will enable students 16 or over to receive up to \$2,500 of EAPs for each 13-week semester of part-time study.

Working Income Tax Benefit (WITB)

Commencing in 2007, a new refundable credit will be available to low-income persons with either employment or business income. The credit will be 20% of earned income in excess of \$3,000 to a maximum credit of \$500 (\$1,000 for couples and single parents). The credit will be reduced by 15% of net family income in excess of \$9,500 (\$14,500 for couples and single parents). The credit will include an additional disability supplement for individuals eligible for the disability tax credit (DTC), of 20% of earned income in excess of \$1,750 to a maximum of \$250.

Registered Disability Savings Plan

Commencing in 2008, any person resident in Canada eligible for the disability tax credit (DTC), or their parent or other legal representative, will be eligible to establish an RDSP. Contributions to an RDSP will not be deductible and the investment income earned in the RDSP will not be taxed while the funds are retained within the RDSP. Funds paid out of the RDSP will be taxable to the extent that they exceed the contributions to the plan.

RDSP contributions will qualify for a Canada Disability Savings Grant at varying rates depending on family net income and the amount contributed. Annual Canada Disability Savings Bond payments of up to \$1,000 will be paid annually to the RDSPs of low and modest-income beneficiaries and families regardless of contributions to an RDSP.

Contributions are limited to a lifetime maximum of \$200,000 for the disabled beneficiary, with no annual limit. There will be no restriction on who can contribute. Contributions can be made until the end of the year in which the beneficiary reaches 59. Contributors will not be entitled to a refund of contributions. Where the beneficiary of a RDSP either ceases to be eligible for the DTC or dies, the funds in the RDSP (net of certain repayments) will be required to be paid to the beneficiary or pass to the beneficiary's estate.

Amounts paid out of an RDSP will not be included in income for purposes of income-tested benefits such as Old Age Security or Employment Insurance benefits. The impact of amounts paid out of an RDSP on payments received under programs of the provinces or territories has yet to be negotiated.

Lifetime Capital Gains Exemptions

The lifetime capital gains exemption will be increased from \$500,000 to \$750,000 for gains realized on dispositions after March 18, 2007. The exemption continues to be available on shares of qualified small business corporation or qualified farm and fishing property. This proposal can benefit individuals who own qualifying property, whether or not they have previously utilized any of the \$500,000 exemption.

Donations to Private Foundations

Beginning March 19, 2007, there will be no tax on capital gains realized on the donation of publicly-listed securities to a private foundation. Additionally, an employee stock option benefit may be non-taxable where an arm's length employee acquires a publicly-listed security through an employer granted option and within 30 days of exercise donates the security to a private foundation. Private foundations will be subject to new excess business holdings rules that will limit the foundation's holdings of shares, including unlisted shares. Such rules will take into account the holdings of persons not dealing at arm's length with the foundation.

Truck Drivers' Meal Expenses

Long-haul truck drivers will be entitled to a larger deduction for meal expenses. The increased deduction will also be available to employers who reimburse costs incurred by long-haul truck drivers. Currently, the deduction is limited to 50% of the costs incurred. This deduction will be increased to 60% for expenses after March 19, 2007 and before 2008, 65% in 2008, 70% in 2009, 75% in 2010 and 80% thereafter. A corresponding GST amendment will allow input tax credits for the increased deduction for meal expenses.

Business Income Tax Measures

Capital Cost Allowance (CCA)

CCA is a deduction for tax purposes that recognizes the depreciation of capital property. CCA rates are intended to reflect the useful life of capital property and provide incentives for areas of the economy that the government wants to encourage.

Proposed Increases to CCA Rates for assets acquired after March 18, 2007:

	Current rate	New Rate
Manufacturing and processing (M&P) machinery and equipment ⁽¹⁾	30%	50% straight line
Buildings used for M&P	4%	10%
Other non-residential buildings	4%	6%
Computer equipment	45%	55%
Natural gas distribution lines	4%	6%
Liquefied natural gas facilities	4%	8%

Note 1. The budget proposes a temporary increase to a 50% straight-line rate for M & P machinery and equipment acquired after March 18, 2007 and before 2009. The assets are subjected to the half-year rule and can be written off on average over a two-year period, starting mid point in year of acquisition. Effectively, the deduction will be 25% in year of acquisition, 50% in following year and 25% in third year.

Accelerated CCA for Clean Energy Generation

The Budget will make additional assets eligible for the accelerated CCA under 43.2 (50%) if they are acquired after March 18, 2007 and before 2020. Eligible equipment must generate heat for use in an industrial process or electricity by using a renewable energy source, wastes fuel or an efficient use of fossil fuels. Eligibility is extended to the a broader range of applications involving active solar heating, photovoltaics, stationary fuel cells, production of biogas from organic waste, and pulp and paper waste fuels.

Investment Tax Credit for Child Care Spaces

To encourage business to invest in child care, businesses will be entitled to a 25% investment tax credit on eligible expenditures to a maximum credit of \$10,000 per child care space created. The primary business of the tax payer must be other than the provision of child care. The new spaces can be in a new or existing licensed facility and can be for the benefit of either children of employees or other children.

Eligible expenditures must be incurred after March 19, 2007 and can include the cost of depreciable property and certain start-up costs such as landscaping an outdoor play area, initial fees for licensing, regulatory and building permits, architectural fees and children's educational material. General operating expenses and expenditures related to most residences will NOT qualify.

Remittance and filing thresholds

The following changes to filing and remittance thresholds have been proposed for taxation years after 2007:

- Personal income tax instalment threshold increasing from \$2,000 to \$3,000.
- Corporate tax instalment threshold increasing from \$1,000 to \$3,000.
- Annual GST filing threshold on taxable supplies increasing from \$500,000 to \$1,500,000. Net tax payable threshold for one remittance will increase from \$1,500 to \$3,000.
- Small CCPCs instalment remittance reduced from monthly to quarterly, if certain conditions are met.
- Quarterly instalment remittance threshold for employee source deduction, increasing to \$3,000 from \$1,000.

International Tax Measures

Foreign Affiliates/Taxing Profits

Canada's major trading partners, notably the U.S. and U.K., have a similar tax regime for income earned by foreign subsidiaries. Active business income is included in taxable income when repatriated while investment income (Foreign Accrual Property Income) is taxed currently whether received or not. Canada is introducing major revisions in this area. Active business income earned by a foreign affiliate in a country with which Canada has a tax treaty is eligible for a full deduction when computing taxable income – such that such after-tax foreign profits are repatriated tax free – even if they have been subject to only 2.5% (Barbados) to 12.5% (Ireland) tax. The taxation of active business earned by foreign subsidiaries in treaty countries is being modified in two ways.

- Non-treaty countries that have “Tax Information Exchange Agreements” (“TIEAs) with Canada will now be given the same treated as treaty partners in this context. That is, active business income earned by subsidiaries in either treaty countries or TIEA countries will be repatriated to a Canadian parent tax-free. Given Canada's already extensive network of tax treaties and relative paucity of TIEAs, relatively few taxpayers will benefit in the short run.
- Active business income earned by a foreign affiliate in a non-TIEA non-treaty country will be FAPI (and be subject to current tax in Canada on an accrual basis if earned by a controlled foreign affiliate). A country will be a “non-TIEA country” only after 5 years have elapsed from the time that Canada and the country have begun TIEA negotiations, or from the time that Canada invited the country to enter into TIEA negotiations.

Restrictions of Canadian Deductions

Even though the profits of foreign subsidiaries earned in treaty countries would never be subject to Canadian tax, the Canadian corporations could finance their foreign investments with debt and were entitled to a tax-deduction in Canada for the interest expense. Not satisfied with a single deduction laid out to earn tax-free income, many corporations used complex structures to obtain “double dip” strategies to effectively obtain a tax deduction both in Canada and the United States for effectively the same interest expense.

Subject to ungenerous transition rules, borrowing costs will be pooled and only deductible in the future and only to the extent that the foreign affiliate's shares generate non-exempt income for the corporation. The rules will apply on all interest payable

- after 2007 debt incurred after March 19, 2007
- after 2008 on all non-arm's length debt (or sooner if term ends before then)
- after 2009 on arm's length debt.

Withholding Tax on Interest

The Canadian Tax Act requires anyone paying interest to a foreign entity to withhold 25% of that interest and remit it to CRA as taxes of the foreign entity, unless certain exemptions apply. That 25% is reduced by most tax treaties Canada negotiates so that the usual effective rate is 10%. Canada has agreed with the U.S., and will work to agree in other treaties, to eliminate the withholding tax on interest, subject to a phase in schedule. Interest paid to arm's length parties will be exempt in the first calendar year after the treaty changes are ratified. Interest paid to non-arm's length parties will be subject to a three (3) year phase in, again starting first calendar year after the treaty changes are ratified.

Once these exemptions are implemented in the Canada-US tax treaty, Canada will unilaterally eliminate Canadian withholding tax on all interest paid or credited to all arm's length non-residents, regardless of their country of residence.

Prescribed Exchanges

Currently, a stock exchange is prescribed if it is either a prescribed domestic exchange or a prescribed foreign exchange. The concept of "prescribed stock exchanges" which impact on issues ranging from RRSP investments to taxation of non-residents is being replaced with a new three-tier system. The new system, with use of tiers 2 & 3 undefined, will reduce compliance issues in obtaining withholding relief for non-residents and it will expedite the recognition of new and reorganized stock exchanges such as the Alternative Investment Market (AIM) of London.

GST Excise Tax and Other Measures

Visitor Rebate Program

As previously announced, effective April 1, 2007 the program ends. A new Foreign Convention and Tour Incentive Program will replace the Visitor Rebate Program.

Travelers' exemption

This increases 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 24-hour and 7-day travel remain unchanged, as do the limits on alcohol and tobacco.

Exports of Intangible Personal Property (IPP)

Exports made after March 19, 2007, of intangible personal property (IPP) made to non-residents who are not registered for GST/HST purposes be zero-rated subject except for the following:

- a supply of IPP made to an individual who is physically present in Canada when the supply is made;
- a supply of IPP that relates to real property situated in Canada or tangible personal property ordinarily situated in Canada;
- a supply of IPP that relates to a service the supply of which is made in Canada and is not a zero-rated export;
- a supply of IPP that may only be used in Canada; and
- a supply of IPP that is prescribed by regulations..

Green Levy on “Gas Guzzlers”

There will be a basic rebate amount of \$1,000 to a maximum of \$2,000 applicable for vehicle purchases or leases (minimum 12 months) after March 19, 2007. This will be matched with a Green Levy of up to \$4,000 for new fuel-inefficient vehicles. The vehicles eligible for rebate will be listed on Transport Canada’s website (www.tc.gc.ca).

This Tax Update provides a general discussion of certain tax developments and you should not rely on it as if it were professional advice. If you require professional advice, please contact us at (416) 250-1212 to discuss the issues raised in this update in the context of your particular circumstances.