

TAX TALK

2008 FEDERAL BUDGET HIGHLIGHTS

On Tuesday, February 26, 2008, the Honourable Jim Flaherty, Minister of Finance, presented his third Budget Statement to Parliament. Set out below are highlights of the budget that we believe to be of most interest to you.

ECONOMIC OVERVIEW

	2007/2008 Estimate (\$billion)	2008/2009 Forecast	Growth %
Revenue	244.5	241.9	(0.1)
Expenditure			
Public debt	33.1	31.5	(4.8)
Other	201.2	208.1	3.4
Debt reduction	10.2	2.3	
Surplus	0.0	0.0	
Net Public Debt	457.1	454.8	

	2007 Estimate %	2008 Forecast %	2009 Forecast %
Inflation	3.1	1.8	1.9
3 Month Treasury Bill Rate	4.2	3.2	3.8
Unemployment Rate	6.0	6.3	6.4
Real Growth in GDP	2.6	1.7	2.4

While the Minister announced no new tax credits or changes to the personal or corporate tax rates, the Budget has proposed a new tax-free savings account for individuals to encourage personal savings. In addition, it proposes other minor tax relief for individuals in the form of adjustments to Registered Education Savings Plans, Medical Expense Credits and Registered Disability Savings Plans.

Business tax measures announced in the Budget included accelerated capital cost allowance for certain eligible manufacturing and processing and increased scientific research and experimental development (SR&ED) limits.

The government's program spending increased 6.8% in the current year, which is in excess of what the government forecast in the 2007 Budget. The growth rate forecast for 2008/09 is 3.4%, but that rate is expected to increase to almost 5% the following year.

The Budget proposes to reduce the debt by \$10.2 billion this year, with further reductions of \$2.3 billion for 2008/09 and \$1.3 billion for 2009/10.

Real growth in GDP for 2008 is forecasted to decline from prior forecasts to 1.7%, but is then expected to increase to 2.4% in 2009. This projected growth is significantly less than projected in the 2007 Budget (2.9% and 3.1% respectively), reflecting many of the "economic challenges ahead".

PERSONAL TAX MEASURES FOR INDIVIDUALS AND FAMILIES

Personal Income Tax Rates

The 2008 Budget does not introduce any new tax rate changes. The top marginal rate for individuals remains at 46.41%. This rate starts to apply when taxable income exceeds \$123,184¹.

The following table summarizes marginal tax rates (on regular income, i.e., salary, interest, etc.) that apply to the income tax brackets for 2008².

Taxable Income	Federal Rate %	Ontario Rate %	Total %
\$ 9,600 to \$ 36,020	15.00	6.05	21.05
\$ 36,021 to \$ 37,885	15.00	9.15	24.15
\$ 37,886 to \$ 63,421	22.00	9.15	31.15
\$ 63,422 to \$ 72,040	22.00	10.98	32.98
\$ 72,041 to \$ 74,728	22.00	13.39	35.39
\$ 74,729 to \$ 75,769	22.00	17.41	39.41
\$ 75,770 to \$123,184	26.00	17.41	43.41
\$123,185 and over	29.00	17.41	46.41

¹ In general, the tax brackets are indexed for inflation to protect taxpayers from automatic tax increases that would otherwise result. For 2008, the brackets have increased by 1.9%. As a result, the top tax rate will apply in 2008 when taxable income exceeds \$123,184 (2007 - \$120,886).

² This table reflects the changes proposed in the federal October 30, 2007 economic statement and the changes proposed in the Ontario December 13, 2007 economic statement.

Tax-Free Savings Account (TFSA)

The Budget includes tax measures designed to encourage Canadians to save more through the introduction of a registered tax-free savings account, available *after 2008* and to operate as follows:

- commencing in 2009, Canadian resident individuals, age 18 or over, will be able to contribute up to \$5,000 annually (indexed annually after 2009 with annual additions rounded to the nearest \$500) to a TFSA. Contributions to a TFSA will **not be deductible** for income tax purposes. Individuals may be permitted to hold more than one TFSA. The investment income [interest, dividends and capital gains] earned or realized within the TFSA will **not be taxable**.
- any portion of the \$5,000 annual contribution limit not utilized in one year can be carried forward indefinitely to a future year. In addition, any amounts withdrawn from the TFSA in a year will be added to the individual's contribution limit in the following year.
- withdrawals from a TFSA can be used for any purpose, and will not be subject to income tax or taken into account in determining eligibility for income-tested benefits or credits (ie. Age credit or Old Age Security benefits).
- any excess contributions over the available limit will be subject to a penalty tax of one per cent per month of the excess.
- interest on money borrowed to invest in a TFSA will **not be tax deductible**. However, unlike RRSPs, the TFSA assets may be used as collateral for a loan.
- a TFSA will generally be permitted to hold the same investments as an RRSP. However, a TFSA will **not** be allowed to hold investments in any entity with which the individual does not deal at arm's length, or of which the individual is a "*specified shareholder*" (generally a 10% or greater ownership interest).
- financial institutions eligible to issue RRSPs will be permitted to issue TFSA's. TFSA issuers will be required to file annual information returns to report the value of an account's assets at the beginning and the end of the year, as well as the amount of contributions, withdrawals and transfers made in the year.

- the Canada Revenue Agency (CRA) will determine TFSA contribution room annually based on tax returns filed. As a result, individuals who have not filed tax returns in prior years will be permitted to establish their entitlement by filing outstanding returns in a later year.
- the income attribution rules will not apply to funds borrowed by a spouse or common-law partner to invest in his/her TFSA.

A TFSA will lose its tax-exempt status upon the death of the plan holder. Consequently, investment income and gains that accrue after the individual's death will be taxable. However, an individual will be permitted to name his/her spouse or common-law partner as the successor account holder, in which case the account will maintain its tax-exempt status. Alternatively, the assets of the deceased's TFSA may be transferred without tax to a TFSA of the surviving spouse or common-law partner.

An amount may also be transferred on the breakdown of a marriage or common-law partnership directly from the TFSA of one party to the TFSA of the other party. This type of transfer will not reinstate the contribution room of the transferor, and will not reduce the contribution room of the transferee.

An individual who becomes a non-resident of Canada will be allowed to maintain his/her TFSA, which will continue to be exempt from Canadian income tax. However, contributions will not be allowed while the individual is a non-resident, and contribution room will not accrue for any year throughout which the individual is a non-resident.

Changes to Registered Education Savings Plan (RESP)

The 2007 federal budget raised RESP contribution limits, and grant amounts. This Budget proposes to increase time periods to contribute to an RESP.

For 2008 and subsequent taxation years, the Budget proposes to extend the time limits to contribute to an RESP by an additional 10 years. Specifically, the number of years to contribute is extended from 21 to 31 years (25 and 35, respectively, for disabled beneficiary plans).

The deadline for termination of the RESP is also to be extended from the 25th anniversary date to the 35th, and the beneficiary age limit for contributions to a family plan will increase from 21 years to 31.

In addition, the Budget proposes, commencing in 2008, to allow RESP beneficiaries to receive Education Assistance Payments for six months after ceasing to be enrolled in a qualifying educational program.

Changes to Registered Disability Savings Plans (RDSPs)

The 2007 budget introduced the RDSP for 2008 and later years. The government is working with financial institutions to put the necessary mechanisms in place to allow institutions to offer RDSPs in 2008.

In order to prevent a premature collapse of an RDSP by the beneficiaries themselves, the Budget proposes a mandatory collapse be permitted to occur only when the beneficiary's condition has factually improved to the extent that the beneficiary no longer qualifies for the Disability Tax Credit.

Increased Tax on Eligible Dividends

The Budget proposes to reduce the dividend gross-up and the dividend tax credit (DTC), in stages, beginning in 2010 which will increase the federal personal tax rate on eligible dividends,³ to reflect previously announced corporate income tax rate⁴ reductions. The Budget proposes to reduce the dividend gross-up from its current 2008 45% gross-up rate to 38% by 2012 and the DTC from 19% currently to 5% by 2012 for eligible dividends. The reductions in the gross-up and DTC of eligible dividends will result in an increase in the effective top **federal rate** on eligible dividends from 14.55% in 2008 to 19.29% by 2012. Ontario income tax will be in addition to the federal tax.

Tax Credits

Medical Expense Tax Credit

Effective for 2008, the Budget proposes to extend the tax credit to the cost to purchase, operate and maintain the following devices prescribed by a medical practitioner:

- altered auditory feedback devices for treatment of a speech disorder;
- electrotherapy devices for the treatment of a medical condition or severe mobility impairment;

³ In general, eligible dividends are dividends that are paid from corporate business income that has been taxed at the high corporate federal income tax rate.

⁴ The general federal corporate income tax rate is scheduled to decrease from 19.5% in 2008 to 15% in 2012.

- 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 eligibility for the cost of service animals specially trained to assist individuals who are severely affected by autism or epilepsy.

In addition, for expenses incurred after February 26, 2008, medications that may be purchased without a prescription are specifically excluded from eligibility for the medical expense tax credit.

Flow-Through Shares

The mineral exploration tax credit available to individuals will be extended to flow-through share agreements entered into by March 31, 2009, which can support eligible exploration until the end of 2010. The program was otherwise intended to expire on March 31, 2008.

BUSINESS TAX MEASURES

Corporate Income Tax Rate

The 2008 Budget does not introduce any new tax rate changes. However, corporate rates are scheduled to decrease pursuant to previously enacted or announced measures.

The following table summarizes federal and Ontario corporate tax rates, with respect to active business income (ABI) earned by a Canadian controlled private corporation in Ontario, and reflects federal and Ontario tax rate reductions to apply in 2008:

Based on a December 31 year end for 2008⁵

Active Business Income	Federal Rate %	Ontario Rate %	Total Rate %
up to \$400,000	11.00	5.50	16.50
from \$400,001 to \$500,000	19.50	5.50	25.00
from \$500,001 to \$1,500,000*	19.50	18.25	37.75
> \$1,500,000	19.50	14.00	33.50
> \$1,500,000 with M&P **	19.50	12.00	31.50

* includes clawback of Ontario small business deduction

** M & P - manufacturing and processing tax credit

⁵ This table reflects the changes proposed in the federal October 30, 2007 economic statement and the changes proposed in the Ontario December 13, 2007 economic statement.

Manufacturing and Processing (M&P): Accelerated Capital Cost Allowance (CCA)

In order to continue to assist the manufacturing and processing (M&P) sector, the Budget proposes to extend for another year, the temporary increase to a 50% straight-line rate in the capital cost allowance (CCA) rates for new M&P machinery and equipment.

Generally, qualifying M&P machinery and equipment would be included in Class 43, which is a 30% declining balance class. The 2007 budget provided that qualifying machinery and equipment acquired before 2009 would go into Class 29, a 50% straight-line class. The Budget extends this qualifying period to assets acquired in 2009.

Eligible assets acquired in 2010 will be included in Class 43 and eligible for a 50% declining-balance rate in the first year 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 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 rate thereafter. To implement this transition, eligible assets acquired in 2010 and 2011 will be placed in separate Class 43 pools. After 2011, the separate pools will be merged.

Class 29 and Class 43 are subject to the half-year rule.

Scientific Research and Experimental Development (SR&ED)

Under the current system, Canadian-controlled private corporations (CCPCs) are entitled to a tax credit or a cash refund of investment tax credits (ITCs) based on the following formula:

Amount of Expenditure	ITC Rate	Refund of ITC
First \$2,000,000	35%	100%
Amount over \$2,000,000	20%	40%

Eligibility for the 35% rate is phased out if the corporate group's taxable capital (as calculated for Large Corporation Tax purposes) exceeds \$10 million or if the corporate group's taxable income exceeded \$400,000 in the preceding taxation year.

The Budget proposes to **increase both the expenditure limit** eligible for the 35% ITC rate and the phase-out ranges for taxation years that end on or after February 26, 2008 (subject to proration for tax years that straddle this date):

	Current	Proposed
Expenditure Limit	\$2,000,000	\$3,000,000
Taxable income phase-out range	\$400,000-\$600,000	\$400,000-\$700,000
Taxable capital phase-out range	\$10,000,000-\$15,000,000	\$10,000,000-\$50,000,000

Due to the increase in the expenditure limit to \$3,000,000, a corporation may now receive an investment tax credit of up to \$1,050,000 [35% of \$3 million] as compared to the current maximum of \$700,000 [35% of \$2 million].

The new phase-out limits, like the old ones, are prorated for short taxation years.

SR&ED Carried on Outside of Canada

A taxpayer cannot currently claim an ITC for SR&ED expenditures carried on outside Canada. The Budget proposes that certain salaries or wages incurred outside of Canada ("*foreign salaries*") with respect to Canadian resident employees on or after February 26, 2008; (subject to proration for years that straddle this date) will be eligible for ITCs. More specifically:

- the taxpayer must directly undertake the activities outside of Canada solely in support of SR&ED that the taxpayer carries on in Canada.
- foreign salary eligible for the ITC will be limited to 10% of the total salaries and wages directly attributable to SR&ED carried on in Canada.
- foreign salaries will not include salaries and wages based on profits or bonus or salary or wages subject to tax in the foreign country.

OTHER TAX MEASURES

Remittance of Source Deductions

Currently there is a penalty of 10% for any late remittance of source deductions. This penalty is increased to 20% when the failure to remit is made knowingly or in circumstances amounting to gross negligence.

The Budget proposes to enact a graduated penalty regime for remittances due after February 26, 2008, as follows:

- 3 % if the remittance is one to three days late;
- 5 % if the remittance is four or five days late;
- 7 % if the remittance is six or seven days late, and
- 10% if the remittance is more than seven days late.

Currently withholdings (with respect to large remitters) must be remitted directly to a financial institution in order to avoid late remitting penalties. The Budget proposes to allow withholdings due on or after February 26, 2008, to be remitted directly to the CRA, without penalty, as long as the remittance is received at least **one full day before** the due date.

Publicly Traded Trusts

Publicly traded income trusts and partnerships (SIFTs) are generally subject to a special tax on distributions. (SIFTs that existed on October 31, 2006, are subject to grandfathering rules which eliminate this tax on distributions until 2011.) The tax is comprised of a federal element (currently 19.5%) and a provincial element (currently 13%).

For 2009 and subsequent taxation years, the provincial element will be computed differently. Distributions will be allocated to the provinces in accordance with the corporate taxable income allocation formula in the regulations. The various provincial corporate rates will then be applied to such allocations to arrive at a composite rate. Distributions not allocated to a province will be taxed at 10%. Distributions allocated to Quebec will not be subject to this provincial element because Quebec imposes its own tax.

Donations of Exchangeable Securities

Currently, a taxpayer donating publicly traded securities to a registered charity or other eligible donee is entitled to a significant tax benefit. Notwithstanding the fact that the excess of the fair market value (FMV) over the tax value of the donated security is not taxed, the taxpayer is credited with a donation equal to the FMV of the donated security.

The Budget proposes to extend this benefit [i.e., the gain not being taxed] to donations, made on or after February 26, 2008, of publicly traded securities acquired in exchange for unlisted securities, if the following conditions are met:

- the securities can be shares or partnership interests.
- at the time of issue, the securities must have been subject to a condition allowing them to be exchanged for publicly traded securities.
- the publicly traded securities must be the only consideration received on the exchange.
- the publicly listed securities so acquired must be donated to a registered charity or other qualified donee within 30 days after the exchange.
- where the unlisted security is a partnership interest, the portion of the gain arising from a cost base reduction due to losses will be taxed.

Expectation of Profit Legislation

Draft legislation, first introduced on October 31, 2003, to be effective for taxation years commencing after 2004, was intended to legislate a “*no reasonable expectation of profit*” rule. The new rules would have had a particularly harsh impact on interest deductibility in many circumstances. In response to harsh criticism from the tax community, the provision is being reviewed by Finance.

INTERNATIONAL

Section 116 Certificates

Currently, when a non-resident disposes of “*taxable Canadian property*” (TCP), unless the vendor has obtained a certificate under section 116 of the Income Tax Act (the Act), the purchaser must withhold and remit a portion of the proceeds to the CRA on account of the non-resident’s possible Canadian income tax liability. Where the purchaser fails to follow these procedures, the purchaser then becomes liable for the tax.

The current system is cumbersome, inefficient and does not take into account gains that are exempt under tax treaties. The Budget proposes to effectively recognize the effect of tax treaties by amending section 116 of the Act to provide an exemption from the purchaser’s withholding requirement for TCP that at the time of disposition is considered to be “*treaty-protected property*”.

For dispositions between related persons, the purchaser will have to file with the CRA, no later than 30 days after the disposition, a notice setting out basic information with respect to the disposition and the vendor.

The Budget also proposes to expand the scope of an existing “*reasonable inquiry*” protection for purchasers of TCP from non-resident vendors to ensure that the purchaser of the property from a non-resident vendor need not withhold tax if:

- the purchaser, after reasonable inquiry, concludes that the TCP is “*treaty-protected*” and that the vendor was resident in that treaty country;
- the property would be “*treaty-protected*” property of the vendor if the vendor were, under the tax treaty referred to above, resident in a particular country; and
- the purchaser sends to the CRA, no later than 30 days after the date of the acquisition, a notice setting out the basic information about the transaction and the vendor.

Finally, where no Canadian taxes are payable by the non-resident, the vendor **may not** have to file a Canadian tax return to report the disposition, as is currently required.

SALES, EXCISE TAX AND OTHER MEASURES

GST/HST Health Measures

Effective February 27, 2008, the Budget will extend GST/HST **exempt status** to a range of health care services, prescription drugs and medical devices.

GST/HST exempt status will apply to supplies of specially designed training to assist individuals to cope with a disability or disorder if:

- the training is supplied by a government;

- the cost of training is fully or partially reimbursed under a government program, or
- a health professional whose services are GST/HST exempt prescribes the training to allow the patient to better cope with the disability or disorder.

Nursing services rendered to a patient by a registered nurse, a registered nursing assistant, a licensed or registered practical nurse or a registered psychiatric nurse will be exempt from GST/HST regardless of where the service is performed.

All supplies of drugs to final consumers will be zero-rated when they are prescribed by health professionals who are authorized to prescribe such drugs under provincial or territorial legislation.

The zero-rating is effective for all supplies made after February 26, 2008 as well as supplies made on or before February 26, 2008, if the GST/HST was neither charged nor collected.

The following medical and assistive devices are to be zero-rated, also to be effective February 27, 2008:

- devices for neuromuscular stimulation or standing therapy prescribed by a medical practitioner;
- chairs for use by individuals with a disability prescribed by medical practitioner;
- chest wall oscillation systems for use in airway clearance therapy, and
- service animals supplied by recognized organizations that are trained to assist individuals with a disability or impairment.

A memorandum of this nature cannot be all encompassing and is not intended to replace professional advice. Its purpose is to highlight tax-planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

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