

TAX TALK

2007 FEDERAL BUDGET HIGHLIGHTS

On Monday, March 19, 2007, the Honourable Jim Flaherty, Minister of Finance, presented his second Budget Statement to Parliament. Set out below are highlights of the budget that we believe to be of most interest to you.

ECONOMIC OVERVIEW

	2006/2007 Estimate	2007/2008 Forecast	Growth %
	(\$billion)		
Revenue	232.3	236.7	1.9
Expenditure			
Public debt	34.1	33.8	(0.9)
Other	189.0	199.6	5.6
Debt reduction	9.2	3.0	
Surplus	0.0	0.3	
Net Public Debt	472.3	469.3	(0.1)

	2006 Estimate	2007 Forecast	2008 Forecast
	%		
Inflation	2.2	1.5	2.0
3 Month Treasury Bill Rate	4.0	4.2	4.2
Unemployment Rate	6.3	6.3	6.4
Real Growth in GDP	2.7	2.3	2.9

As indicated in the tables above, the surplus for the 2006/2007 fiscal year is projected to be \$9.2 billion, which is to be directed entirely to reduce debt. For 2007/2008, the surplus is forecast to be \$3.3 billion, with \$3 billion of it directed to pay down debt.

This budget contains many tax proposals, a major one being the increase in the lifetime capital gains exemption from \$500,000 to \$750,000 on sales of qualified properties by individuals. In addition, the age limit at which an individual's RRSPs must mature will increase from 69 to 71. The limits for RESPs will increase and a new incentive measure to help provide long-term financial security for the disabled was introduced.

Personal and corporate tax rates will not change and there will be no further reductions to the goods and services tax rate.

The budget increases spending by more than \$10 billion in certain targeted areas - more money for families, children and seniors, and more funds to protect the environment.

Real growth in GDP for 2007 is forecasted to decline from prior forecasts to 2.3%, but is then expected to increase to 2.9% in 2008. Factors expected to cause the lower growth rate in 2007 include reduced productivity in the Canadian economy, a slowdown in the U.S. housing market which will reduce U.S. consumer spending more than anticipated, and the continued volatility of oil prices.

PERSONAL TAX MEASURES

Lifetime Capital Gains Exemption

The lifetime capital gains exemption will be increased from \$500,000 to \$750,000 for gains realized on dispositions after March 18, 2007 of qualified farm and fishing property and qualified small business corporation shares.

Personal Income Tax Rates

The 2007 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 \$120,886.¹

¹ In general, the tax brackets are indexed for inflation to protect taxpayers from automatic tax increases that would otherwise result. For 2007, the brackets have increased by 2.2%. As a result, the top tax rate will apply in 2006 when taxable income exceeds \$120,886 (2006 - 118,286).

The following table summarizes marginal tax rates (on regular income, i.e., salary, interest, etc.) that apply to the income tax brackets for 2007.

Taxable Income*	Federal Rate %	Ontario Rate %	Total %
\$ 8,930 to \$ 35,487	15.50	6.05	21.55
\$ 35,488 to \$ 37,177	15.50	9.15	24.65
\$ 37,178 to \$ 62,488	22.00	9.15	31.15
\$ 62,489 to \$ 70,975	22.00	10.98	32.98
\$ 70,976 to \$ 73,624	22.00	13.39	35.39
\$ 73,625 to \$ 74,356	22.00	17.41	39.41
\$ 74,357 to \$120,886	26.00	17.41	43.41
\$120,887 and over	29.00	17.41	46.41

* tax brackets are generally indexed for inflation to protect taxpayers from automatic tax increases that would otherwise result.

Age Limit for Maturing RPPs and RRSPs

The budget proposes to increase the age at which Registered Pension Plans (RPPs) and Registered Retirement Savings Plans (RRSPs) mature from the end of the year in which the RRSP annuitant or RPP member turns 69 to 71. As proposed, commencing in 2007 individuals will be able to make RRSP contributions to their own RRSP up to, and including, the year in which they turn 71, subject to available contribution room.

The minimum annual withdrawal from a Registered Retirement Income Fund (RRIF) will be waived for 2007 and 2008 for annuitants who turn 70 in 2007. It will be waived for 2007 for annuitants who turn 71 in 2007. A RRIF annuitant who is 71 or younger 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 71 or younger at the end of 2007.

Phased Retirement

The Income Tax Regulations will be amended to allow an employee to receive pension benefits from a defined benefit RPP, of up to 60% of their accrued defined benefit pension, while accruing additional pension benefits on a current service basis while they continue to work. Qualifying employees must be at least 55 years old and eligible to receive a pension without incurring an early retirement reduction.

Employment after the commencement of the pension can be either full-time or part-time. This approach will give employers a great deal of flexibility in designing older-worker retention programs. However, the *prohibition* on accruing additional benefits while receiving a pension will still apply to designated plans as well as to persons who are “connected” with their employer, as would generally be the case with an Individual Pension Plan (IPP). This new measure will be effective for 2008 and subsequent taxation years.

RRSP Qualified Investments

The list of qualified investments for RRSPs and other registered plans will be broadened 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 as well as any security, other than a futures contract, which is listed on a designated stock exchange.

Registered Education Savings Plans (RESP)

The budget proposes to eliminate the maximum annual contribution limit of \$4,000 per child for Registered Education Savings Plans (RESP), and increase the lifetime limit from \$42,000 to \$50,000. In addition, the maximum annual RESP contribution per child qualifying for the 20% Canada Education Savings Grant (CESG) will increase from \$2,000 to \$2,500 for 2007 and subsequent years, thereby increasing the annual education savings grant from \$400 to \$500. The lifetime CESG limit of \$7,200 per child will, however, not increase.

The RESP rules will be relaxed for 2007 and subsequent years for part-time programs so that the required 10 hours per *week* to be spent on courses is reduced to 12 hours per *month*. Educational Assistance Payments can be distributed from the RESP - up to \$2,500 will be allowed for each 13-week semester of qualifying part-time study.

Registered Disability Savings Plan (RDSP)

The budget proposes a new Registered Disability Savings Plan (RDSP) a tax enhanced savings plan, expected to commence in 2008, to help provide long-term financial security for disabled individuals who are eligible for the disability tax credit. The mechanics of the RDSP will be similar to that of the RESP. Any person resident in Canada eligible for the disability tax credit (DTC), their parent or other legal representative, will be eligible to establish an RDSP. There will be no restriction on who can contribute to the RDSP, however, contributors will not be entitled to a refund of their contributions.

Although contributions to an RDSP will *not be deductible*, the investment income earned in the RDSP will *accumulate tax-free* until withdrawn from the RDSP. Contributions to an RDSP will be limited to a lifetime maximum of \$200,000 for the disabled beneficiary, with no annual limit. Contributions can be made until the end of the year in which the disabled beneficiary reaches 59.

RDSP contributions will qualify for a Canada Disability Savings Grant (CDSG), to a lifetime grant limit of \$70,000, on contributions until the end of the year in which the beneficiary reaches age 49. Families with income of up to \$74,357, will receive a grant of 300% on the first \$500 contributed and an additional 200% of the next \$1,000 contributed.² Families with income in excess of \$74,357 will receive 100% of the first \$1,000 contributed.

Independent of contributions to the plan, where family income is less than \$20,833, the RDSP will also be paid an annual Canada Disability Savings Bond (CDSB) of \$1,000³ to a lifetime limit of \$20,000. The CDSBs will continue until the end of the year in which the beneficiary reaches 49.

Payments from an RDSP⁴ must commence by the end of the year in which the beneficiary reaches 60. Only the beneficiary or their legal representative will be allowed to receive payments. On withdrawal of funds from the RDSP, original capital contributions will not be subject to tax on withdrawal, but investment income, CDSGs and CDSBs will be taxed at the time of withdrawal.

When a beneficiary ceases to qualify for the DTC or dies, the RDSP will be required to repay all CDSGs and CDSBs (and the related investment income) received by the plan in the ten years prior to wind-up of the plan. Any remaining funds in the RDSP, net of capital contributions, will then be taxable to the beneficiary, or their estate.

Truck Drivers' Meal Expenses

Long-haul truck drivers will be entitled to a larger deduction for meal expenses, increasing from 50% of the costs incurred to 60% for expenses after March 19, 2007 and before 2008, 65% in 2008, 70% in 2009, 75% in 2010 and 80% thereafter.

² To illustrate, the annual grant on a \$1,500 contribution made by a family with income up to \$74,357, would be \$3,500.

³ The maximum amount of \$1,000 per year will be reduced when family net income exceeds \$20,883 and fully eliminated when income exceeds \$37,178.

⁴ Payments will be subject to an annual maximum determined by reference to life expectancy and the value of the plan.

A corresponding GST amendment will allow input tax credits for the increased meal expense deduction.

Working Income Tax Benefit

Commencing in 2007, and subject to certain restrictions, a new Working Income Tax Benefit *refundable* tax credit will be available to low and modest-income residents with employment or business income. The credit will be 20% of earned income in excess of \$3,000 to an annual maximum of \$500 or \$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).

Scholarships

Currently, scholarships and bursaries received by students in post-secondary programs qualifying for the education credit are fully exempted from tax. The budget extends the exemption to students in elementary and secondary schools.

Donations to Private Foundations

The zero capital gain for donations of qualifying publicly-listed marketable securities to *public* foundations will be extended to donations made after March 18, 2007 to *private* foundations. Similarly, the employment benefit associated with the exercise of stock options of a publicly-listed company by an arm's length employee may now also not be taxable where the related securities are donated to a private foundation within 30 days of exercising the option.

Private foundations will be subject to special excess business holdings rules which can 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.

Age Credit, Pension Splitting

The budget reinforced proposals introduced in October 2006 to increase the age credit from \$4,066 to \$5,066 effective for 2006, and allow spouses (or common-law partners) to split qualifying pension income after 2006.⁵

⁵ Qualifying pension income includes most types of retirement income received on a periodic basis, but does not include Canada Pension Plan (CPP) and Old Age Security pension amounts. Spouses have already been able to "share" CPP benefits to achieve income splitting. To share CPP benefits, an application must be made to Services Canada.

Non-Refundable Credits for Dependents

Commencing in 2007, a new non-refundable credit may be claimed for children under the age of 18 at the end of the year. The credit is based on \$2,000 and will result in a reduction in income tax payable of \$310 per child⁶ in 2007.

The credit for a spouse or wholly-dependent person which may be claimed for 2007 will be increased from \$7,581 to \$8,929. However, the amount of \$759 which a spouse may earn without reducing the credit will be eliminated. The previously announced increases to the basic personal credit, whereby it will increase to \$10,000 for 2009, will also apply to this credit.

Public Transit Tax Credit

In 2006, a new Public Transit Credit was introduced for *monthly* passes purchased on public transit systems. Effective January 1, 2007, this tax credit will be extended to cost-per-trip electronic payment cards if the cards are used for at least 32 one-way trips in a 31-day period. In addition, four consecutive weekly passes will qualify for the credit where they provide for unlimited transit use for a period of five to seven days.

Mineral Exploration Tax Credit

The 15% mineral exploration tax credit has been extended for another year. This will apply to flow-through share agreements entered into before March 31, 2008 if the expenditures are incurred before the end of 2009.

BUSINESS TAX MEASURES

Corporate Income Tax Rate

The 2007 budget does not introduce any new tax rate changes. 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:

Based on a December 31 year end for 2007

Active Business Income	Federal Rate * %	Ontario Rate %	Total Rate %
up to \$400,000	13.12	5.50	18.62
from \$400,001 to \$1,128,529**	22.12	18.67	40.79
> \$1,128,529	22.12	14.00	36.12
> \$1,128,529 with M&P ***	22.12	12.00	34.12

⁶ The \$310 income tax saving would be increased to \$431 if Ontario were to also introduce the credit.

- * including federal surtax of 1.12%
- ** includes clawback of Ontario small business deduction
- *** M & P - manufacturing and processing tax credit

Capital Cost Allowance (CCA)

The following CCA rate changes were announced, to apply to assets acquired after March 18, 2007:

Assets	From	To
Manufacturing and processing (M&P) machinery and equipment (1)	30%	50%
Buildings used for M&P (2)	4%	10%
Other non-residential buildings	4%	6%
Computer equipment (3)	45%	55%
Natural gas distribution lines	4%	6%
Liquefied natural gas facilities	4%	8%

Notes

1. The proposed 50% rate is straight-line and subject to the half-year rule. The increase is temporary and applies to M&P machinery and equipment acquired before 2009.
2. A least 90% of the square footage of the building must be used for M&P by the end of the taxation year of acquisition.
3. The tax shelter property rules will be extended to computer equipment that is eligible for the new 55% rate. If applicable, these rules will limit CCA to the income from the property.

The budget also proposes to make additional assets eligible for accelerated CCA under Classes 43.1 (30%) and 43.2 (50%) if they are acquired after March 18, 2007 and are used to produce clean energy through certain emerging technologies.

Investment Tax Credit for Child Care Spaces

Eligible businesses⁷ 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 expenditures must be made to create new child care spaces for the either children of employees, or for children of the surrounding community.

Eligible expenditures incurred after March 19, 2007 include the cost of eligible depreciable property and other start-up expenses including landscaping an outdoor play area, initial licensing fees, regulatory and building permits, architectural fees and the cost of children's educational materials.

⁷ The primary business cannot be the provision of child care services.

Personal and operating expenses will not qualify for the credit, and the credit will be subject to recapture if, within 60 months, either the property is sold/leased to another person, or a change in the use of the property occurs.

INTERNATIONAL

Foreign Affiliates – Interest Expense

Some Canadian corporations have been earning business income outside of Canada through subsidiaries situated in low tax jurisdiction countries with which Canada has a tax treaty, e.g. Barbados. Under this planning, the offshore earnings could be subject to a very low rate of foreign tax when earned, and the income would not be subject to either non-resident withholding taxes or Canadian taxes when repatriated back to the holding company in Canada. In many cases, the Canadian holding company would borrow funds to invest in the offshore company and claim an interest deduction against its other income. The budget proposes to restrict the deduction of this interest by the Canadian company.

Effective for new debt incurred after March 19, 2007,⁸ the interest on such debt used to finance foreign affiliates will be subject to a restricted interest deduction. The restricted interest will be tracked and carried forward, and will be deductible only if and when the foreign affiliate's shares produce income that is subject to tax in Canada.

Foreign Affiliates – Exempt Surplus

Currently, if a foreign affiliate is resident in a country with which Canada has a tax treaty, after-tax active business income earned by the affiliate is considered exempt surplus, and not subject to further taxation in Canada when received by the Canadian holding company. The budget proposes to extend this advantage for affiliates resident in a country with which Canada does not have a treaty, but has entered into a Tax Information Exchange Agreement with.

If, however, the country in which the income is earned has not entered into a Tax Information Exchange Agreement with Canada, the offshore income will now be taxed in Canada on the accrual basis. In the past, such income has been taxed in Canada only when distributed by the offshore company to the Canadian holding company as a dividend.

⁸ The interest restriction is to apply to interest on existing non-arm's length debt after 2008 and existing arm's length debt after 2009.

Withholding Tax on Interest

Both Canada and the U.S. have agreed to eliminate withholding tax, currently 10%, on interest payments to residents of the other jurisdiction. Where interest is paid or credited to an *arm's length* party,⁹ the withholding tax will be eliminated in the first calendar year following the entry into force of the amendment to the tax treaty.

The budget also proposes that Canada eliminate Canadian withholding tax *on all interest* paid or credited to arm's length non-residents of *all other countries* on or after the date on which the withholding tax exemption in the proposed Canada-U.S. Tax Treaty comes into effect.

SALES AND EXCISE TAX

Green Levy on "Gas Guzzlers"

A new tax on fuel inefficient vehicles is being introduced for new vehicles delivered to dealers or imported after March 19, 2007. The levy will apply to new automobiles designed primarily to carry passengers including station wagons, vans and SUVs, but not pick-up trucks. The levy will range from \$1,000 to \$4,000 per vehicle depending on the vehicle's weighted average fuel consumption starting at 13 litres consumed per 100 kilometres and higher. The levy will be payable by the manufacturer or importer at the time the vehicles are delivered to a purchaser (usually a dealer) or imported.

The levy will not apply to vehicles that are manufactured in Canada for export, to vehicles in dealer inventory on March 19, 2007, or where a sales agreement with the final consumer is entered into before March 20, 2007 and calling for delivery before July 2007.

Rebate for Fuel Efficient Vehicles

The government is introducing a program to provide rebates on the purchase of certain fuel efficient vehicles.¹⁰ The basic rebate amount of \$1,000 to a maximum of \$2,000 is applicable for vehicle purchases or leases (minimum 12 months) after March 19, 2007. The payment of rebates is expected to begin in the fall of 2007 once administration and delivery systems have been put in place.

⁹ For interest paid or credited to a non-arm's length party, the rates will gradually reduce to 7% in the first calendar year following the entry into force of the amendment, 4% in the second calendar year and eliminated in the third calendar year.

¹⁰ The vehicles eligible for rebate will be listed on Transport Canada's website (www.tc.gc.ca).

48 Hour Travelers' Exemption

Travelers returning to Canada after March 19, 2007 will be allowed to bring back goods valued at up to \$400 (previously \$200) without having to pay duties or taxes, including customs duty, GST/HST and federal excise tax, provided they have been out of Canada for 48 hours or more.

ADMINISTRATIVE MEASURES

Instalments

The threshold requiring **individuals** to make quarterly instalments will be increased from \$2,000 to \$3,000 for the 2008 taxation year.

The federal instalment threshold for **corporations** will be increased from \$1,000 to \$3,000 for taxation years commencing after 2007.

To be effective for taxation years commencing after 2007, certain Canadian-controlled private corporations will be allowed to make quarterly instalments instead of monthly instalments. To qualify for this measure the company must be entitled to the small business deduction, the

taxable income of the associated group must not exceed \$400,000 and the taxable capital of the associated group must not exceed \$10 million, all three criteria to be met in either the current or previous year. In addition, within the past 12 months, the company must have had no compliance irregularities under the Income Tax Act or GST portions of the Excise Tax Act.

Employers with annual source deduction remittances of less than \$1,000 and a perfect compliance history can remit source deductions on a quarterly, rather than monthly, basis. Commencing in 2008, the threshold will increase to \$3,000. The CRA will advise an employer if they are eligible for quarterly remittances.

GST/HST Annual Filing and Annual Remittance Thresholds

For fiscal years that begin after 2007, the taxable supplies threshold at or below which registrants can file a GST/HST return *annually* will be increased from \$500,000 to \$1,500,000, and the net tax threshold before being required to make quarterly instalments of GST/HST will be increased from \$1,500 to \$3,000.

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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