

# Tax Alert

## Federal Budget 2008



Quality In Everything We Do

**“Our government is meeting the challenge of global economic uncertainty with a plan that is real. A plan that is responsible. A plan that is working.”**

- *The Honourable Jim Flaherty, Minister of Finance,  
2008 Budget Speech, February 26, 2008*

More than two years into its mandate, the minority Conservative government brought down its third budget on February 26. The budget is consistent with the framework for long-term tax reduction and focused spending, as well as greater support for certain sectors facing economic challenges.

Throughout the budget documents, the minister refers to the significant tax reductions announced in the October 30, 2007, Economic Statement, which have since been enacted.

### Highlights of the 2008 federal budget include:

- Accelerated capital cost allowance deductions.
- Increased scientific research and experimental development expenditure base for Canadian-controlled private corporations.
- Introduced new registered Tax-Free Savings Account.
- Revised gross-up and tax credit for eligible dividends.
- No corporate or personal income tax rate changes.

### Business Income Tax Measures

#### Corporate Tax Reductions

While there were no new corporate tax reduction measures, the minister stated that Canada’s corporate tax rate will become the lowest among the major industrialized economies, thanks to the general federal corporate income tax rate reductions enacted in December 2007. The minister reaffirmed the government will seek the collaboration of the provinces and territories to reach a 25% combined corporate tax rate.

The enacted Canadian federal corporate income tax rates are summarized in the accompanying table. No increase was announced to the \$400,000 of annual business income of a Canadian-controlled private corporation (CCPC) eligible for the reduced small business tax rate.

	General Corporate Rate	Small Business Rate
2007*	22.12%	13.12%
2008	19.50%	11.00%
2009	19.00%	11.00%
2010	18.00%	11.00%
2011	16.50%	11.00%
2012	15.00%	11.00%

\* The 2007 rates include the 1.12% federal surtax that was eliminated as of Jan. 1, 2008.

#### Significant Changes to Capital Cost Allowance System

Following on with the theme of last year’s budget, the minister announced changes to capital cost allowance (CCA) rates to continue to align them with the useful life of the underlying assets. In addition, he broadened the eligibility of the types

of assets and time frames to be eligible for accelerated CCA incentives. Furthermore, he presented draft amendments and explanatory notes to the income tax regulations to give effect to both the 2008 and 2007 budget measures.

### **Aligning CCA Rates with Useful Life**

To better reflect the typical useful life of certain assets, selected CCA rates have been increased for assets acquired after the budget date. The CCA rate on railway locomotives or on railway locomotive refurbishment costs of a capital nature will be increased from 15% to 30%. The CCA rate on carbon dioxide pipelines will be increased from 4% to 8%, and the CCA rate on carbon dioxide pumping and compression equipment will be increased to 15%.

### **Accelerated Capital Cost Allowance for Clean Energy Generation**

The 2007 budget expanded the eligibility of certain energy-generation equipment qualifying for a 50% accelerated CCA claim. The 2008 budget extends this list to include ground-source heat pumps and biogas production equipment. Furthermore, many of the user restrictions have been eliminated. This will expand the range of business models in which technologies eligible for the CCA incentives can qualify.

### **Temporary Incentive for Manufacturing and Processing Machinery and Equipment**

Further to last year's proposal to temporarily increase the CCA rate for manufacturing and processing equipment to a 50% straight-line rate, the incentive has been extended for three years. Specifically, the 50% straight-line CCA treatment will apply for one additional year, and the accelerated treatment will then be provided on a declining basis over a two-year period. In addition, the proposed regulations provide for the ability to make a separate class election.

### **Taxation of SIFT Trusts and Partnerships**

The budget proposes that for a specified investment flow-through (SIFT) trust's 2009 and subsequent taxation years, the provincial component of the SIFT tax (and thus a province's share of the resulting revenue) be based on the general provincial corporate income tax rate in each province in which the SIFT has a permanent establishment. The interprovincial allocation will be based on a formula similar to that used by corporations and will allocate a SIFT's taxable distributions based on gross revenues and salaries and wages attributable to a permanent establishment in a particular province. Taxable distributions not allocable to a particular province will be subject to a 10% rate, and taxable distributions allocable to Quebec will not be subject to tax to take into account the SIFT tax imposed by that province.

In the context of a SIFT trust, it is understood that based on

discussions with officials from the Department of Finance it is not intended that the proposed income allocation rules look through to the underlying operations of a SIFT trust's subsidiary entities. Thus, because most SIFT trusts would generally not employ any persons directly, nor would any of a SIFT trust's gross revenue generally be attributable to a particular permanent establishment, we expect that all of a SIFT trust's taxable distributions would be subject to tax at the provincial rate applicable to the province in which the SIFT trust's head office is located.

On December 20, 2007, Finance announced the release of certain technical amendments to clarify the application of the SIFT rules. In general, these technical amendments should provide relief for numerous issues facing SIFTs and improve the international competitiveness of Canadian real estate investment trusts. The minister also previously announced his intention to allow SIFTs to convert to corporate form generally on a tax-deferred basis. The budget confirmed the government's intention to proceed with the previously announced measures.

## **International Tax Measures**

### **Cross-Border Investment – Section 116 Certificates**

Budget 2008 removes a cumbersome barrier for non-residents investing in Canada. Unfortunately, the changes will mainly apply to related-party transactions and will likely apply in more limited circumstances to arm's-length transactions.

The budget proposes to amend and thereby streamline Section 116 in three ways.

First, the requirement to withhold tax will be removed where the property disposed of is "treaty protected" property. If the disposition is between related persons, the purchaser must send to the minister within 30 days of the disposition a notice that contains the basic information about the transaction and the vendor.

Second, a purchaser need not withhold on transactions involving treaty-protected property provided:

- It has concluded after reasonable inquiry that the vendor is resident in the treaty country,
- The property would be treaty protected under that treaty, and
- The purchaser sends to the minister a notice that contains the basic information about the transaction and the vendor within 30 days.

Third, the requirement for the non-resident vendor to file a Canadian tax return will be aligned with the Section 116 requirement above. Generally, the non-resident vendor will be exempt from filing a Canadian tax return in respect of dispositions of taxable Canadian property (TCP), provided the following criteria are satisfied:

- No tax is payable under Part I for the taxation year,
- The non-resident is not currently liable to pay any amount under the *Income Tax Act* in respect of any previous taxation year, and
- Each TCP disposed of in the year is “excluded property,” which now includes treaty-protected property, or a property for which the minister has issued to the non-resident a certificate under Section 116.

These changes will apply in respect of dispositions that occur after 2008.

## Scientific Research and Experimental Development

The budget proposes to improve the scientific research and experimental development (SR&ED) tax incentive program, including its administration.

The Department of Finance and the CRA embarked on a consultation process in November 2007 that resulted in over 150 submissions from various stakeholders. Many pointed out that the expenditure limit for the 35% SR&ED investment tax credit (ITC) for CCPCs has remained unchanged since the program’s introduction in 1985.

The 2008 budget proposes to increase the expenditure limit from \$2 million to \$3 million. The expenditure limit is phased out for larger corporations using a formula based on the taxable income and the taxable capital for the corporation’s previous taxation year. The previous year’s taxable income also impacts the CCPC’s entitlement to refundable tax credits. The expenditure limits continue to be subject to phase-out rules where the prior year’s taxable income exceeds \$400,000.

The phase-out formula will also continue to erode the expenditure limit at the rate of \$1 for every \$10 of taxable income that exceeds \$400,000. As a result of the increase in the expenditure limit to \$3 million, a total phase-out will occur when the prior year’s taxable income exceeds \$700,000.

The amount of taxable capital that begins to phase out the expenditure limit remains at \$10 million. However, a total phase-out will now occur at \$50 million of taxable capital, taking into consideration the increased expenditure limit and providing for a slower phase-out. The taxable capital phase-out starting at \$10 million continues the inequity for capital-intensive industries.

Over the years, Finance has received many requests to consider SR&ED performed outside Canada as qualified expenditures

earning SR&ED tax credits. Salaries and wages of Canadian residents for SR&ED performed outside Canada incurred after February 25, 2008, will be considered qualified expenditures, as long as the work is directly undertaken by the taxpayer and solely in support of SR&ED carried on by the taxpayer in Canada. This will be limited to 10% of the total salaries and wages directly attributable to SR&ED carried on in Canada by the taxpayer during the taxation year, pro-rated to reflect the number of days in the taxation year that are after February 25, 2008. Such salaries will exclude remuneration based on profits or bonuses. Moreover, salaries subject to an income or profits tax imposed by a foreign country will not be considered qualified expenditures, favouring short-term assignments depending on local tax laws and treaties.

To fund various initiatives to improve the administration of the SR&ED program, the CRA will increase its internal budget by \$10 million.

## Remittance of Source Deductions

The *Act* and *Regulations* provide for penalties in the event of late remittance of withholding of income tax at source. The proposals will reduce the penalties for late remittances if the remittance was received on or before the seventh day after the day the remittance was otherwise due. The reduced penalties are graduated and are as follows:

- If the amount is received within three days of when it was due, the penalty is 3%.
- If the amount is received four or five days after it was due, the penalty is 5%.
- If the amount is received six or seven days after it was due, the penalty is 7%.

The penalty is currently 10%, and will remain at 10% for remittances received after the seventh day following the due date.

A penalty of 3% will apply where the remittance was received by the due date but such remittance was not paid in the manner required. However, all remitters may make payment directly to the CRA, without penalty for not remitting to a financial institution, provided that the CRA receives the payment the day before the day the payment was due.

These changes are being made in response to a CRA pilot program to reduce the frequency of late remittance of income tax withholdings at source. These same changes will also be implemented for the remittance of CPP and EI withholdings at source.

## Tax Relief for Individuals and Families

The budget included no personal tax rate changes and no new tax credits. However, there were a number of proposals that will provide additional tax relief to individuals. Of particular note, the government has proposed a new Tax-Free Savings Account (TFSA).

### Registered Savings

**New Registered Tax-Free Savings Accounts** – After a number of years of speculation, this budget proposes the introduction of TFSA's, savings plans that can be used for any purpose at any time.

Beginning in 2009, Canadian-resident individuals age 18 and older will be permitted to contribute up to \$5,000 annually (indexed annually) to these registered accounts. Contributions will not be tax deductible. However, income earned in the plans will not be taxable and all withdrawals will be tax free.

Like RRSPs, to the extent that an individual does not make a full contribution, the unused contribution room will carry forward indefinitely, available for contribution in a subsequent year. Unlike RRSPs, any amounts withdrawn from a TFSA in a year will be added to the individual's contribution room in the subsequent year, allowing the recontribution of the withdrawn amount. Excess contributions will be subject to a penalty tax.

Other features include the following:

- Eligible investments generally include the same investments as an RRSP, but investments in any entities with which the account holder does not deal at arm's length are not permitted.
- Interest on funds borrowed to contribute to a TFSA is not deductible.
- TFSA assets may be used as collateral for loans.
- Attribution does not apply to funds transferred to spouses or common-law partners to contribute to TFSA's.
- TFSA's can be retained after ceasing Canadian residence and will continue to accumulate tax free. However, during the period of non-residence, contributions cannot be made and contribution room is not earned.
- TFSA's may be transferred on a tax-free basis to a spouse or common-law partner on death or to a former spouse on marital breakdown.

**Changes to Registered Education Savings Plans** – Beginning in 2008, the budget proposes 10-year extensions for time limits and age limits relating to registered education savings plans (RESPs). The number of contribution years is extended from 21 years to 31 years (25 and 35, respectively, for disabled beneficiary

plans). The deadline for termination of the plan is extended from the 25th anniversary date to the 35th (30th and 40th, respectively, for disabled beneficiary plans) and the beneficiary age limit for contributions to family plans is extended from 21 years to 31. In addition, the period for receiving Education Assistance Payments is extended to include a six-month grace period after the beneficiary ceases to be enrolled in a qualified program.

**Changes to Registered Disability Savings Plans** – The budget proposes that this program, which was introduced in last year's budget and came into effect in 2008, be subject to review every three years. In addition, to prevent a premature collapse of these plans by beneficiaries, the budget proposes that a mandatory collapse of the plan is only required where the beneficiary's condition has improved such that he or she no longer qualifies for the disability tax credit.

### Dividend Tax Credit

In response to the reduction in corporate tax rates from 19.5% in 2008 to 15% in 2012, the dividend gross-up factor and the dividend tax credit for eligible dividends will be correspondingly reduced. By 2012, an eligible dividend will be grossed-up by 38% (compared to 45% currently) and the dividend tax credit will be reduced to 15% from the current level of 19%. These changes will result in an increase in the effective federal tax rate on eligible dividends from 14.55% to 19.29% by 2012, assuming no further tax rate changes.

Therefore, by 2012 the rates for eligible and ineligible dividends will be virtually the same.

### Other Tax Credits

- **Medical Expense Tax Credit** – Effective 2008, a number of expenditures have been added to the list of expenses eligible for the medical expense tax credit (METC), including a number of devices prescribed by medical practitioners and a variety of expenses relating to service animals specially trained to assist individuals who are severely afflicted by autism or epilepsy. In addition, effective February 26, 2008, medications that may be purchased without a prescription are specifically excluded as eligible for the METC.
- **Mineral Exploration Tax Credit** – The mineral exploration tax credit will be extended for flow-through share agreements entered into on or before March 31, 2009. This program had previously been extended and was scheduled to expire on March 31, 2008.

## Donation of Exchangeable Securities and Other Charity-Related Changes

Prior federal budgets introduced a series of incentives to increase giving to registered charities and other qualified donees. Currently, the capital gain normally resulting on the gifting of publicly traded securities is eliminated, making it more attractive to donate appreciated qualifying securities. This incentive has now been broadened to include certain exchangeable securities. However, new rules are also being introduced to exclude from exemption capital gains arising from reductions to the adjusted cost base of certain securities that are partnership interests.

The conversion of certain unlisted exchangeable shares or partnership interests into publicly traded securities may give rise to a capital gain or loss on conversion. The gain realized on conversion can be avoided if the converted publicly traded securities are gifted to a registered charity provided:

- The unlisted security was exchangeable into the publicly traded security at the time of issue,
- The publicly traded securities are the only consideration received on exchange, and
- The publicly traded securities are donated within 30 days of exchange.

Donated exchangeable securities that are partnership interests will give rise to a taxable gain where the adjusted cost base has been reduced, generally by operating losses.

Effective for donations after February 26, 2008, only the amount of gain that represents the economic appreciation of the partnership interests is exempt. The portion of the gain that arises from reductions to the adjusted cost base of the partnership interest will now need to be recognized in income by the donor.

This taxable gain will be computed as the lesser of

- The taxable capital gain otherwise determined, and
- One-half of the amount, if any, by which the cost to the donor exceeds the adjusted cost base to the donor.

It is understood based on discussions with the Department of Finance that these rules will not apply to securities that are flow-through shares, only partnership interests. Accordingly, with flow-through shares it will still be possible to deduct allowable renounced deductions and then gift those shares without the resulting gain being taxable. It is not clear from the budget whether this rule will apply to limited partnership interests where the limited partnership has invested in flow-through shares.

Other changes in the charity realm include a proposal to relieve private foundations from the obligation to dispose of certain holdings of unlisted shares, as first announced in the 2007 budget. In addition, the anti-avoidance rules related to such holdings will now be extended to cover certain inappropriate uses of trusts.

Also, additional categories of charities will now be eligible to receive donated medicine from inventory with the donor eligible to claim the “special additional deduction,” as first announced in the 2007 budget.

## Sales and Excise Tax Measures

The budget proposes to modify the application of the GST/HST to a range of health-care services, prescription drugs and medical devices, applicable to supplies made after February 26, 2008. These changes are generally relieving in nature.

The budget also contains measures to ensure that the GST new residential rental property rebate (which came into effect on February 28, 2000) and GST/HST-exempt treatment applies to long-term residential care facilities. This change generally applies on a going-forward basis, but may also apply to certain past transactions where the owner has paid tax on the facility or elects to have the new rules apply.

In addition, the budget proposes to provide GST/HST relief in respect of property leases in respect of wind and solar power. This measure applies to supplies made after February 26, 2008, and to consideration payable after that date in respect of supplies made before that date.

## Other Measures

The budget proposes a number of changes to enhance tobacco taxation, enforcement and compliance, and some minor changes to the duty on certain tobacco products. It also contains measures to treat imitation spirits like genuine spirits, rather than like beer.

## Previously Announced Measures

The government confirmed its intention to go ahead with a number of previously announced measures:

- **Taxation of financial institutions** – Draft legislation of November 7, 2007, would simplify the taxation of financial institutions as a result of the changes in financial reporting of financial instruments contained principally in CICA Handbook Section 3855. The draft legislation generally confirms intentions set out in a Department of Finance backgrounder released December 28, 2006.

- **Foreign affiliate rules** – Draft legislation was first introduced in 2002 and revised in 2004. Some of the measures were enacted by Bill C-28. However, a number of the 2004 proposals—including all of the amendments relating to the reorganization of foreign affiliates—remain outstanding.
- **SIFT trusts and partnerships** – On December 20, 2007, the government announced technical modifications to SIFT trusts and partnerships, as well as measures to facilitate the conversion of SIFTs to corporations.
- **ITC carryforward** – The government announced on January 21, 2008, its intention to extend the carryforward period for unused federal ITCs earned by Canadian businesses between 1998 and 2005 to 20 taxation years from the current 10. Credits earned after 2005 are already eligible for the 20-year period.
- **GST/HST for financial services sector** – The government proposed improvements to the application of the GST/HST to the financial services sector on January 26, 2007.

### Other Legislation

**Canada-U.S. Tax Treaty** – With the enactment of Bill S-2 on December 14, 2007, Canada has completed the “Canadian” steps required to give effect to the fifth protocol to the *Canada-United States Income Tax Convention*. The protocol will come into effect once it has been ratified by the United States and the two countries have formally notified each other that their procedures are complete. No timetable has been announced for the U.S. ratification process.

The protocol introduces a wide range of amendments affecting both corporate and individual taxpayers, including revisions to the permanent establishment rules, corporate continuance and residence, withholding tax on related-party interest payments, the taxation of hybrid entities, the limitation of benefits provisions and pre-emigration and post-immigration planning.

**Bill C-10 (Formerly Bill C-33)** includes the proposed foreign investment entity and non-resident trust rules, restrictive covenant rules, matchable expenditure rules and a number of technical amendments, some of which are retroactive to 1999. Bill C-10 was deemed to have passed all the stages in the House of Commons on October 29, 2007, and received second reading in the Senate on December 4, 2007. The Bill is currently being held up by the Senate Committee on Banking, Trade and Commerce pending further hearings on a number of aspects of the non-resident trust provisions.

**Reasonable Expectation of Profit** – No mention was made of this in the budget documents of these October 31, 2003, proposals.

### Webcast

To view Ernst & Young’s Webcast of budget highlights, visit our Web site: [ey.com/global/content.nsf/Canada/Tax\\_-\\_Tax\\_Alerts](http://ey.com/global/content.nsf/Canada/Tax_-_Tax_Alerts)

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