

# Tax Alert

## Federal Budget 2007 – Aspire to a Stronger, Safer, Better Canada

 **ERNST & YOUNG**

*Quality In Everything We Do*

### **“Canada’s Tax Advantage will...continue to reduce personal income taxes...[and] establish the lowest tax rate on new business investment in the G7.”**

*- The Honourable Jim Flaherty, Minister of Finance, Economic and Fiscal Update, November 2006*

With a year under its belt, the minority Conservative government brought down its second federal budget on March 19. There has been much speculation that a federal election could be just around the corner, and some of the measures announced in today’s budget do appear to be election-year promises for Canadian taxpayers. However, other changes—notably in the international arena—represent major policy shifts which will adversely affect the financing of foreign operations of multinational corporations.

Last November, in his economic and fiscal update, Finance Minister Jim Flaherty outlined the Four Core Principles intended to guide the federal government’s future economic policymaking. The 2007 budget provides a timetable for several tax measures as they relate to these Principles.

#### **1) Focusing Government**

- Legislating the “Tax Back Guarantee,” dedicating all interest savings from the shrinking federal debt to personal income tax reductions. This will deliver \$1.1 billion in personal tax rate reductions for fiscal 2007-08, with a projected rise to \$1.3 billion by 2008-09.
- If the 2006-07 surplus is higher than current projections, the additional interest savings will be allocated to personal income tax reductions in the 2008 budget.

#### **2) Freeing Businesses to Grow and Succeed**

- Enhancing tax assistance for manufacturers.
- Aligning capital cost allowance deductions to reflect an asset’s useful life.
- Providing a financial incentive to the provinces to assist in the elimination of provincial capital taxes.
- Attracting foreign investment to Canada through the elimination of non-resident withholding tax on arm’s-length interest payments generally (and on all interest payments between Canada and the U.S.).
- Harmonizing provincial sales tax with the GST. The government reaffirmed its commitment to work with the provinces to eliminate their retail sales taxes and move to a harmonized federal-provincial system.

### 3) Investing for Sustainable Growth

- Expanding incentives for the generation of clean energy.
- Introducing public-private partnerships for infrastructure.
- Providing new scientific research and experimental development incentives. While no new measures were announced, over the coming year the federal government plans to improve the SR&ED program, including its administration.

### 4) Creating New Opportunities and Choices for People

- Continuing to reduce personal income taxes through a series of focused tax credits—including the Working Income Tax Benefit (WITB), the \$2,000 child tax credit, raising the spousal amount, increasing the age limit for converting RRSPs.
- Enhancing the capital gains exemption for farmers, fishers and small business investors.
- Broadening capital gains deferral opportunities. No new measures were announced.
- Reducing the GST rate to 5% no later than 2011. No timetable has been announced.

Following are some of the specific tax-related highlights of the 2007 federal budget.

## International Tax Measures

The minister has proposed fundamental changes to the taxation of Canadian companies that do business abroad. The proposed general elimination of withholding tax on interest is part of the government's plan to enhance Canadian corporations' access to global capital markets. On a significantly less positive note, the other international tax measures are intended to "crack down" on Canadian multinational companies that use "tax havens" to avoid paying their "fair share" of taxes.

### Withholding Tax on Interest

The lobbying efforts of several groups in the tax community have been successful. The minister announced that Canada and the United States have agreed in principle that the amended Canada-U.S. treaty will eliminate withholding tax on interest paid between persons in Canada and the United States. This change will apply to payments between non-arm's-length parties as well as arm's-length parties. In the former case, the elimination of withholding tax will be phased in over a three-year period starting in the first calendar year following the entry into force of the treaty changes.

The minister also announced that Canada will unilaterally amend its domestic legislation to eliminate withholding tax on arm's-length interest payments. This change will become effective on the same date on which the withholding tax exemption comes into effect in the amended Canada-U.S. treaty.

### Restricted Interest Deductions on Investments in Foreign Affiliates

The minister proposes to disallow the deduction of interest on borrowed money used to make investments in foreign affiliates, except to the extent that taxable income is generated by the affiliate. This change represents the most significant tax policy development in the international arena since the foreign affiliate rules were first introduced in 1972. Although, as the budget plan observes, the mismatch between interest deductions and tax-free returns from foreign affiliates has been subject to negative commentary for at least a decade, the government has repeatedly defended the current regime. Today's announcement, which will have significant fiscal implications for many Canadian multinationals, was largely unanticipated. The coming-into-force provisions are not generous; interest paid after 2009 on existing unrelated debt will be affected.

The proposed disallowance applies to both interest and "other borrowing costs" (not defined) and to all manner of investments in foreign affiliates, including the acquisition of foreign shares or indebtedness, lending or contributing capital, or otherwise using borrowed money to earn income from a foreign affiliate. The disallowance also catches indirect investments, where the borrower and the investor are not the same person. The proposed changes include a specific anti-avoidance rule that catches series of transactions. The proposed rules operate through the mechanics of a "disallowed interest pool."

Other proposed changes to the foreign affiliate rules result in "qualifying interest" becoming the new standard for the deeming rules applicable to interaffiliate charges and related business activities. These rules will largely affect foreign companies whose Canadian subsidiaries enter into financing or other arrangements with sister companies in other jurisdictions. In response, we anticipate that Canadian subsidiaries will invest in preferred stock of the related foreign companies.

## Tax Information Exchange Agreements (TIEAs)

The government is evidently serious about improving the exchange of information with the tax authorities of jurisdictions in which Canadian companies do business. It has announced that no new treaties will be signed that do not include comprehensive exchange-of-information provisions. In order to encourage foreign governments to enter into TIEAs with Canada, the minister has proposed to broaden exempt surplus to include active business income earned in non-treaty countries that have signed TIEAs. Non-treaty countries will be asked to agree to a TIEA within five years of being approached by Canada to do so. The income earned in a jurisdiction that does not agree will be taxable in Canada as foreign accrual property income as it is earned. On a related note, the government will provide the CRA with additional resources to allow it to pursue transfer pricing and international tax avoidance cases.

## Business Income Tax Measures

### Corporate Tax Reductions

While there were no *new* corporate tax reduction measures, the minister confirmed the timetable for the enacted general corporate rate reductions: from 21% to 20.5% effective January 1, 2008, 20% effective January 1, 2009, 19% effective January 1, 2010; and the previously announced reduction to 18.5% effective January 1, 2011.

The minister also confirmed that the corporate surtax of 4% of federal tax will be eliminated for all corporations effective January 1, 2008, pro rated for taxation years that include that date.

### Significant Changes to Capital Cost Allowance System

Capital cost allowance (CCA) is a deduction for tax purposes in recognition of the depreciation of certain capital assets used to gain or produce income. In his November economic statement, the minister committed to review the rates at which capital assets are depreciated for tax purposes and align those rates with the useful life of the assets.

In addition to changing the rates applicable to certain depreciable assets, other significant changes include the elimination of incentives where they are no longer warranted, and encouraging investment in the manufacturing and processing equipment and the development of clean alternative energy sources.

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

The budget proposes several changes to improve alignment of the CCA rates to the useful life of the asset being depreciated. Bringing the CCA rates in line with the useful life of an asset will reduce the tax burden on investment and increase the efficiency of the tax system.

#### **Proposed Increases to CCA Rates**

<b>Asset</b>	<b>Current Rate</b>	<b>New Rate</b>
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%

The new rates will apply to assets acquired on or after March 19, 2007. The half-year rule will continue to apply, such that timing of acquisition just before a year end would provide for faster write-off.

#### *Accelerated Capital Cost Allowance for Oilsands*

Tangible equipment used to produce income from an oilsands project is currently afforded an accelerated CCA claim to offset some of the risk associated with large capital investment required to bring such a project to production. The budget proposes to phase out this additional allowance. The current accelerated CCA system will continue to be available for assets acquired before March 19, 2007, and assets acquired before 2012 on projects where major construction commenced before March 19, 2007. For assets not eligible for

the continued accelerated CCA treatment, the current accelerated CCA system will continue to 2010, after which time it will be progressively phased out by 2015.

Planned expenditures in the next few years on oilsands projects are expected to exceed \$100 billion. Given the significant proportion of these expenditures that will be spent on tangible equipment, it is expected these changes will have a major impact on taxpayers already committed to significant capital investment.

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

Energy-generation equipment used to produce either heat for use in an industrial process or electricity by using a renewable energy source, waste fuel or the efficient use of fossil fuels is currently afforded a 50% accelerated CCA claim. The budget proposes to extend eligibility for this accelerated claim to include wave and tidal energy and 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.

These changes apply to eligible assets acquired after March 19, 2007.

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

The budget proposes to temporarily increase the CCA rate for manufacturing and processing machinery and equipment otherwise included in Class 43 to a 50% straight-line rate. The half-year rule will apply, such that a full write-off should be obtained over three taxation years. This increased rate will apply to assets acquired after March 19, 2007, and prior to 2009.

### **Facilitating the Elimination of Provincial Capital Taxes**

The budget proposes a temporary financial incentive to provinces imposing a capital tax to support and encourage them to eliminate such taxes to further strengthen Canada's business tax advantage.

To be eligible for the incentive, a province must eliminate its existing general capital tax or capital tax on financial institutions, or restructure its existing capital tax on financial institutions into a minimum tax on financial institutions. The elimination or restructuring must take effect on or before January 1, 2011, and the enabling legislation must be enacted on or after March 19, 2007, and before 2011.

The amount of the financial incentive each province will receive will correspond to the federal corporate income tax revenue gain from qualifying provincial capital tax reductions. The new financial incentive will be calculated at a specified rate, being the estimated average effective federal corporate income tax rate times the estimated provincial revenue loss from capital tax reductions relating to the period from March 19, 2007, to January 1, 2011.

No details as to the determination of the loss in capital tax revenues by the provinces have been provided.

### **Remittance and Filing Thresholds**

**Increase in corporate income tax instalment threshold and reduction in instalment frequency for small business** – The budget proposes to increase the threshold amount above which corporations are required to pay corporate income tax to \$3,000 from \$1,000 for taxation years beginning after 2007. In addition, for CCPCs that are required to pay tax instalments, the frequency of instalments will be reduced to quarterly from monthly if:

- Taxable income for either the current or previous year does not exceed \$400,000;
- The corporation qualifies for the SBD in the current or previous year;
- Taxable capital employed in Canada does not exceed \$10 million in either the current or previous year; and
- The corporation has met all compliance requirements under the *Income Tax Act* (ITA) and *Excise Tax Act* (ETA) in relation to GST/HST.

The three methods that will be available for computing instalments are the same as those applicable in respect of individual tax instalments.

**Increase in quarterly instalment remittance threshold for source deductions** – The budget proposes to increase the threshold for remitting employees' source deductions on a quarterly basis to \$3,000 from \$1,000. The change applies to calendar years beginning with 2008.

**Increase in GST/HST annual filing and remittance thresholds** – The budget proposes to triple the taxable supplies threshold at or below which registrants can file a GST/HST return annually. For fiscal years beginning after 2007, the \$500,000 threshold is increased to \$1.5 million. The net tax threshold below which annual GST/HST filers can make one remittance is doubled to \$3,000 from \$1,500.

## Prescribed Stock Exchanges

In collaboration with a number of professional firms and industry associations, Ernst & Young's submissions to the minister to relax the section 116 certification requirements as they apply to shares of Canadian corporations listed on foreign stock exchanges have been successful. These efforts have finally paid off, with a comprehensive and sensible proposal to update the concept of "prescribed stock exchange" that is currently used for a variety of purposes under the ITA.

Budget 2007 proposes to replace the lists of currently prescribed stock exchanges with a new three-tier system of "Designated Stock Exchanges," "Recognized Stock Exchanges" and "Stock Exchanges." Each term will be applicable for different purposes of the ITA.

The new system will lower tax barriers both for domestic investors in international markets and for international investors in Canadian companies. It will also expedite the recognition of new and reorganized stock exchanges such as the Alternative Investment Market (AIM) of the London Stock Exchange (LSE). The AIM is a securities market established by the LSE in June 1995 to meet the needs of smaller, growing companies which might not fulfil the criteria for a listing on the main market of the LSE or for which a more flexible regulatory environment is more appropriate.

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

## ITCs for Child Care Spaces

Budget 2007 proposes a new tax credit for eligible businesses that create one or more new child-care spaces in a new or existing licensed child-care facility. The new non-refundable investment tax credit is equal to 25% of eligible expenditures, to a maximum credit of \$10,000 per child-care space created.

## Tax Relief for Individuals and Families

The budget does not include any personal tax rate reductions or increases in tax bracket amounts.

### Working Income Tax Benefit

As expected, this budget includes a new Working Income Tax Benefit (WITB), a refundable tax credit for low-income working Canadians. This credit, effective 2007, for individuals who are at least 19 years of age at the end of the year, is equal to 20% of earned income (income from employment or business) in excess of \$3,000, to a maximum credit of \$500 for single individuals and \$1,000 for families.

To target low-income families, the credit is reduced by 15% of net family income (as computed for purposes of the Child Tax Benefit in excess of \$9,500 for single individuals and \$14,500 for families). Students with no dependants enrolled in full-time studies for more than three months are not eligible for the WITB.

Beginning in 2007, the WITB also includes an additional disability supplement for each eligible individual, other than a dependant, who is eligible for the disability tax credit and who has a least \$1,750 of earned income. The additional credit is equal to 20% of the individual's earned income in excess of \$1,750, to a maximum credit of \$250. This supplement is reduced by 15% of net family income in excess of \$12,833 for individuals and \$21,167 for families.

The budget proposes a prepayment mechanism for the WITB beginning in 2008. One-half of an individual's estimated WITB will be prepaid as part of the GST credit cycle. Prepayments will only be made where applicants provide adequate evidence of anticipated earned income and proof of Canadian residency.

### Registered Disability Savings Plan

This budget proposes a new Registered Disability Savings Plan (RDSP) with a Canada Disability Savings Grant (CDSG) program and Canada Disability Savings Bond (CDSB) program. The RDSP will be based generally on the existing Registered Education Savings Plan (RESP) design. The government will work with financial institutions to put the necessary administrative mechanisms in place (for example, for paying CDSGs and CDSBs to RDSPs) to allow financial institutions to begin offering RDSPs to Canadians as soon as possible in 2008.

### RESPs

The minister proposes a number of measures that make education savings using RESPs more flexible, including:

- Eliminating the \$4,000 annual maximum contribution
- Increasing the lifetime maximum contribution to \$50,000 (from \$42,000)
- Increasing the amount of annual contribution eligible for the 20% CESG to \$2,500 from \$2,000
- Extending the RESP eligibility to more part-time studies by relaxing the EAP eligibility requirements to programs that require at least 12 hours per month on courses (currently 10 hours per week).

These changes are generally to be effective beginning in 2007.

### New Child Tax Credit

This budget proposes a new non-refundable child tax credit, beginning in 2007, for each child under the age of 18 years at the end of a taxation year. The tax credit, which may be claimed by either parent (the parent who claims a dependant credit in respect of the child for separated parents) will be calculated as \$2,000 multiplied by the lowest personal income tax rate for the taxation year (15.5% in 2007). This new credit provides personal income tax relief of up to \$310 per child.

### Lifetime Capital Gains Exemption

Despite the government's election promise to provide relief in respect of the taxation of capital gains, the budget only includes an increase in the current capital gains exemption. Capital gains realized on the disposition of qualified farm and fishing property or qualified small business corporation shares on or after March 19, 2007, will be eligible for a lifetime maximum exemption of \$750,000 (from \$500,000). Transitional rules are proposed for the 2007 taxation year.

### Other Personal Tax Measures

- Elementary and secondary school scholarships – Scholarships and bursaries for elementary and secondary schools will be fully exempt from tax beginning in 2007.
- Spousal and other amounts – The spousal and other personal amounts will be increased to match the basic personal amount beginning in 2007 (\$8,929 for 2007).
- Public Transit Tax Credit – The public transit tax credit will be enhanced by extending eligibility to the cost of certain electronic payment cards and weekly passes (when at least four consecutive weekly passes are purchased).
- Meal expenses for truck drivers – The deductible portion of the cost of food and beverages consumed by long-haul truck drivers will be increased to 80% (from 50%) over five years, beginning with expenses incurred after March 19, 2007.
- Mineral Exploration Tax Credit – This credit, which was scheduled to expire at the end of March 2007, has been extended to flow-through share agreements entered into on or before March 31, 2008.
- Increase in personal income tax instalment threshold – The budget proposes to increase the income tax threshold for individual tax instalments to \$3,000 (\$1,800 for Quebec residents), from \$2,000 (\$1,200 for Quebec residents). This change will apply to the 2008 and subsequent taxation years.

### Retirement Income

In an attempt to retain workers longer in the workforce and to enrich their ultimate retirement benefits, the government proposes several enhancements to the rules governing RPPs and RRSPs.

To help employers enhance their older-worker retention programs, the *Income Tax Regulations* will be amended to allow workers to continue accruing pension benefits for work performed with the same employer after retirement or partial retirement.

Currently, taxpayers are required to stop contributing to their RRSPs and start a withdrawal program, usually through a Registered Retirement Income Fund (RRIF), by the end of the year in which they turn age 69. Budget 2007 proposes to extend this deadline to age 71.

Transition rules are also available for taxpayers who turn 70 and 71 in 2007 by allowing certain RRSP contributions for the 2007 and 2008 taxation year to the extent of available deduction room. In addition, these taxpayers can waive the minimum withdrawal requirement from their existing RRIFs for 2007 and 2008.

And, as a measure to increase the flexible investment opportunities for RRSPs and RRIFs, eligible investments of these vehicles will be immediately expanded 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) that is listed on a designated stock exchange.

### Charitable Giving

The budget proposes to extend to private foundations the zero-inclusion rate for income and gains arising from gifts of publicly listed securities made on or after March 19, 2007.

The change will place gifts to private foundations on the same footing as gifts to public foundations. However, in order to restrict potential self-dealing opportunities, private foundations that hold more than 2% of all the outstanding shares of any class of stock of a corporation will be subject to annual monitoring and reporting to the Canada Revenue Agency. In cases where combined holdings of the charity and non-arm's-length persons are greater than 20%, divesture and/or penalties will result.

The budget also provides a special deduction to corporations that donate from their inventory of medicines to charities that receive disbursements under a Canadian International Development Agency program in respect of activities of the charity carried on outside Canada.

### Sales and Excise Tax Measures

On September 25, 2006, the government announced the elimination of the Visitor Rebate Program, which refunded the GST on accommodations supplied to non-resident visitors. In response to submissions from the tourist and convention industry sectors, a new rebate program will be introduced for conventions or hotel stays after March 31, 2007.

Foreign conventions in Canada (generally where more than 75% of attendees are non-resident) will be eligible for rebate of the GST in respect of facilities and supplies for conventions that begin after March 31, 2007. Also, exemptions will be available to non-residents on registration fees for admission to Canadian conventions, and rebates will be available for the GST on accommodations for non-resident individuals who acquire a tour package which starts after March 31, 2007.

For Canadian travellers leaving the country for more than 48 hours but less than seven days, their exemption on goods brought back into the country after March 19, 2007, increase from \$200 to \$400.

### GST Harmonization Encouraged

On the heels of the Canada-Ontario Memorandum of Agreement on corporate tax collection, the federal government is encouraging the provincial governments to harmonize their provincial sales taxes with the GST. This would remove retail sales taxes from most business inputs, thereby reducing the cost of investment. Moreover, it would make the tax system simpler for businesses and consumers, and streamline government administration.

### Canada-U.S. Tax Treaty

The budget notes that the two countries' representatives have agreed in principle on the major elements of an updated Canada-U.S. Treaty, with formal negotiations expected to conclude in the near future. Specific benefits from the treaty update include:

- Elimination of the withholding tax on all arm's-length and non-arm's-length debt
- Extension of treaty benefits to limited liability corporations
- Harmonization of the tax treatment of pension contributions
- New rules to clarify the treatment of stock options.

### Outstanding Tax Proposals

**Taxation of non-resident trusts and foreign investment entities** – Draft legislation was reintroduced in Bill-C33, which received first reading in the House of Commons on November 22, 2006.

**Foreign affiliate rules** – Draft legislation was first introduced in 2002 and revised technical amendments were released in 2004. The minister indicated his intention to reintroduce revised proposals this spring.

**Deductibility of interest and other expenses (REOP rules)** – The proposals released on October 31, 2003, will be modified substantially and more generous draft legislation is expected by the fall of 2007.

**Cross-border share-for-share exchanges** – The minister indicated that these proposals are not a priority at this time, as there are a variety of tax strategies available to achieve the same result.

## Webcast

To view the Ernst & Young's Webcast of the budget highlights, visit <http://eyo.tax.ca/Budget07>.

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