TaxNewsFlash-Canada
AUDIT ▪ TAX ▪ ADVISORY
KPMG Canada

February 26, 2008
No. 2008-09

Highlights of the 2008 Federal Budget

Today Finance Minister Jim Flaherty delivered the Conservative government's third budget, projecting a surplus of $10.2 billion for 2007-08, which will be applied to pay down the national debt.

The budget contained a variety of tax changes, including the introduction of tax-free savings accounts, enhanced tax incentives for research and development and a variety of capital cost allowance changes.

Highlights of tax changes announced in today's budget are summarized below.

Personal Tax Changes

Tax-free Savings Accounts (TFSA) — The budget introduces a new form of registered savings accounts. Starting in 2009, individuals age 18 and over who are resident in Canada can contribute up to $5,000 annually to their TFSA. Individuals will want to review their retirement savings strategies to ensure they have an appropriate mix of TFSAs and RRSPs. Key features of these new plans are as follows:

- Contributions to TFSA will not be deductible.
- Withdrawals will be tax-free.
- Income, losses and gains on investments in the account, as well as amounts withdrawn, will not be taxable, and they will not be taken into account for determining eligibility for certain income-tested benefits or credits.
- The $5,000 annual contribution limit will be indexed to inflation in $500 increments for 2010 and later years.
- Unused contribution room can be carried forward indefinitely.
- Amounts withdrawn in a year will be added to the following year's contribution room, allowing individuals to re-contribute the equivalent of withdrawn amounts in future years.
- TFSAs will generally be allowed to hold the same qualified investments as Registered Retirement Savings Plans, except for investments in non-arm's length entities (including entities of which the account holder is a "specified shareholder" or has an interest of 10% or greater, together

with non-arm's length persons).

- Interest on funds borrowed to invest in a TFSA will not be deductible. TFSA assets can be used as collateral for loans.
- The attribution rules will not apply to TFSA contributions made to spousal plans (subject to the spouse's contribution room) or on the income generated by such contributions.
- On the death of an account holder, investment income earned in the TFSA after death will no longer be tax-exempt. The TFSA assets will be transferable to the TFSA of the surviving spouse on death.
- Individuals who become non-resident can maintain their existing TFSA and continue to be exempt from tax on investment income and withdrawals. While non-resident, however, no new contributions will be permitted and no new contribution room will accrue.

Registered Education Savings Plans (RESP) — For 2008 and later years, the budget proposes to increase certain time limits associated with RESPs as follows:

- The number of years for which contributions can be made after plan is entered into is extended to 31 years (from 21 years), and to 35 years (from 25 years) for plans of beneficiaries eligible for the disability tax credit (DTC).
- The deadline for terminating the plan is the year that includes the plan's 35th anniversary (formerly 25th anniversary), or 40th anniversary (formerly 30th anniversary) for plans of beneficiaries eligible for the disability tax credit (DTC).
- No contributions will be allowed for family plans for beneficiaries age 31 or older (up from age 21 or older).

Additionally, RESP beneficiaries will be allowed to receive education assistance payments from the plan for up to six months after ceasing to be enrolled in a qualifying program, for 2008 and later years. (Currently, the beneficiary must have been currently enrolled to receive such payments).

Medical expense credit — The budget clarifies that drugs and medications that can only be purchased with a prescription are eligible for the medical expense tax credit, for expenses incurred after February 26, 2008. The list of eligible expenses is expanded to include, among other things, the cost of service animals trained to help people with autism or epilepsy.

Registered Disability Savings Plans (RDSP) — In the 2007 budget, the government said it would introduce Registered Disability Savings Plans, broadly modeled after the existing RESP, to help parents save for long-term financial security of children with severe disabilities. The 2008 budget says the government is working with financial institutions to put administrative mechanisms in place to allow them to offer RDSPs, with the objective of making such plans available in 2008.

Mineral exploration credit — The budget extends the mineral exploration tax credit for flow-through share investors, which was set to expire at the end of March 31, 2008. The credit will continue to be available for flow-through share agreements entered into on or before March 31, 2009.

Dividend tax credit (DTC) — For 2010 and later years, the dividend gross-up factor and DTC will be adjusted in increments to reflect the corporation tax reductions to 15% in 2012 introduced in the October 30, 2007 mini-budget (for details on the corporate tax cuts, see *TaxNewsFlash-Canada 2007-28)*.

Capital gains — Donations of exchangeable securities — The existing capital gains exemption for donations of publicly traded securities is extended to capital gains realized on the exchange of unlisted securities that are shares or partnership interests for publicly traded securities under certain conditions. Generally, the taxable capital gain to be recognized on the exchange of a partnership interest under this proposal will be the lesser of:

- the taxable capital gain otherwise determined
- one-half of the amount by which the cost to the donor of the exchanged units exceeds the donor's adjusted cost base of those interests (without reference to distributions of partnership capital.

This change applies to donations made on or after February 26, 2008.

Capital gains — Excess corporate holdings of private foundations— The 2007 budget introduced an excess business holdings regime for private foundations. The regime placed limits on foundation shareholdings that take into account the holdings of persons not dealing at arm's length with the foundation.

The 2008 budget provides an exemption from this regime for certain holdings of shares that are not listed on a prescribed stock exchange and that were held on March 18, 2007. The 2008 budget also introduces technical amendments dealing with entrusted shares and substituted shareholdings, and extends an existing anti-avoidance rule regarding interests in corporations held via trusts. The amendments will apply to taxation years that begin on or after March 19, 2007.

Business Tax Changes

SR&ED — Thresholds and Limits for Enhanced ITC Rate — The budget proposes to enhance the tax incentives to scientific research and experimental development (SR&ED) for medium-sized CCPCs by:

- increasing the maximum qualified expenditures on which investments tax credits (ITC) can be earned at the enhanced rate of 35% to $3 million (from $2 million)
- increasing the upper phase-out limit for prior-year taxable income for accessing the enhanced ITC rate to $700,000 (from $600,000)
- increasing the upper phase-out limit for prior-year taxable capital to $50 million (from $15 million).

These changes, summarized in the charts below, will have effect for tax years ending on or after February 26, 2008, prorated based on the number of days in that tax year that are after February 25, 2008.

Enhanced SR&ED ITC Limits and Phase-out Ranges		
	Current	**Proposed**
Expenditure limit	$2 million	$3 million
Taxable income phase-out range	$400,000 - $600,000	$400,000 - $700,000
Taxable capital phase-out range	$10 million - $15 million	$10 million - $50 million

Maximum Fully Refundable ITCs Earning with $3 Million Expenditure Limit				
	Taxable Income			
Taxable Capital	**$400,000**	**$500,000**	**$600,000**	**$700,000**
$10 million	$1,050,000	$700,000	$350,000	$0
$20 million	787,500	525,000	262,500	0
$30 million	525,000	350,000	175,000	0
$40 million	262,500	175,000	87,500	0
$50 million	0	0	0	0

SR&ED carried on outside Canada — Eligibility for SR&ED ITCs is extended to eligible salaries and wages in respect of Canadian-resident employees carrying on SR&ED activities outside Canada, provided those activities are directly undertaken by the taxpayer and done solely in support of SR&ED carried on by the taxpayer in Canada. For this purpose, eligible salary and wages are limited to 10% of the taxpayer's total SR&ED salary and wages carried on in Canada in the year. This measure applies to salary and wages incurred on or after February 26, 2008 (prorated for tax years straddling that date).

SR&ED administrative improvements — In response to submissions by

KPMG and others during the government's consultations on how to improve the SR&ED program and its administration, the budget says the Canada Revenue Agency (CRA) will introduce a new claim form and guide and an eligibility assessment tool. The CRA will also review its policies and procedures to ensure they are aligned with current business practices and consistently applied across the country.

The government plans invest $10 million annually to help the CRA improve program administration by, among other things, increasing the number of technical reviewers who determine scientific eligibility and enhancing the quality assurance methodology at the national and local levels, including real-time review of claim decisions.

Temporary CCA rate increase for M&P assets — The budget proposes to extend the temporary increase in the capital cost allowance (CCA) rate for manufacturing and processing (M&P) machinery and equipment currently included in Class 29 to a 50% straight-line rate (from 30%) as follows:

- The 50% straight-line rate will now apply to eligible assets acquired on or after March 19, 2007 and before 2010 (instead of before 2009).
- M&P equipment acquired in 2010 will be eligible for a 50% declining balance rate in the first year ending after the assets were acquired, for a 40% rate in the second year, and a 30% rate in the third year.
- M&P equipment acquired in 2011 will be eligible for a 40% declining balance rate in the first year ending after the assets were acquired and for a 30% declining balance rate in the second and later years.

Other CCA changes — The budget proposes the following CCA rate changes:

- Eligibility for inclusion in CCA class 43.2 Clean Energy Generation (50%) is extended to include:
  - Qualifying round source heat pump systems
  - Additional feedstocks for eligible biogas production systems
  - Equipment used to produce heat from waste sources and equipment used to produce bio-oil (regardless of whether the taxpayer operates the waste-to-energy facility).

- The CCA rate for rail locomotives acquired on or before February 26, 2008 (and not used, nor acquired for use before that date) is increased to 30% (from 15%).

- The CCA rate for carbon dioxide pipelines is increased to 8% (from 4%), and the rate for pumping and compression equipment (and ancillary equipment) on a carbon dioxide pipeline is increased to 15%.

Section 116 certificates — Under the current rules in section 116 of the *Income Tax Act*, purchasers of taxable Canadian property from non-resident vendors must remit withholding tax (WHT) on the vendor's behalf unless the vendor has obtained a section 116 certificate from the CRA verifying that the tax has been paid. For dispositions after 2008, section 116 certificate procedures will be simplified by:

- Exempting from WHT dispositions by non-residents of treaty-protected property
- Ensuring that a person who purchases property from a non-resident is not liable for WHT in certain circumstances
- Eliminating the need for a non-resident to file a Canadian federal income tax return in certain circumstances where no Canadian federal tax is payable.

Tax on specified flow-through entities (SIFT) — Provincial component — Currently, the SIFT tax applies at a rate comprised of two components: the first equal to the federal general corporate tax rate and a second additional tax in lieu of provincial tax at a rate of 13%.

The budget proposes that, for 2009 tax years and later, the provincial component of the SIFT tax will be based instead on the general provincial corporate income tax rate in each province in which the SIFT has a permanent establishment.

To determine the rate for a particular SIFT, the taxable distributions of the SIFT will be notionally allocated to provinces according to the general corporate taxable income allocation formula. Taxable distributions that are not allocated to any province would instead be subject to tax at the rate of 10%. The provincial rate applied to taxable distributions allocated to Quebec will be deemed to be nil to take into account that province's SIFT tax.

Sales Tax Changes

GST/HST health measures — The budget proposes several measures regarding the application of GST/HST to health care services, prescription drugs and medical devices for supplies made after February 26, 2008, including the following changes:

- Nursing services rendered by a registered nurse and certain other registered nursing professionals are exempt from GST, regardless of where the service is performed.
- All supplies of drugs to final consumers will be zero-rated if they are

prescribed by health professionals who are authorized to prescribe them (including nurse practitioners and midwives).

- The list of zero-rated medical and assistive devices is expanded
- Health professionals' services will be treated as GST/HST exempt regardless of whether the services are supplied by the health professional directly or through a corporation.

Long-term residential health care facilities — The budget proposes to clarify that the GST New Residential Rental Property Rebate and GST/HST exempt treatment apply to long-term residential health care facilities "on a going forward basis". The change also applies to past transactions where the owner has paid tax on the facility or elects to have the new rules apply. The current condition that residential units in the facility be "supplied" to individuals under a lease, licence or similar arrangement will be replaced with a requirement that the "possession" or "use" of the residential units in the facility be given to individuals for the purpose of their occupancy.

Self-assessment rules — In response to a recent court decision, the GST/HST self-assessment rules will be amended to clarify that they apply whether either "possession" or "use" of a residential unit in a residential facility is given to an individual under a lease, licence or similar arrangement for the purpose of occupying the unit as a residence. This change will allow owners that constructed or substantively renovated long-term residential care facilities to benefit from the new GST/HST residential property rebate.

This change applies after February 26, 2008, and to transactions on or before that date where the owner has self-assessed GST/HST or an election to claim the new residential property rental rebate has been made.

Tobacco taxation — The budget proposes several changes to enhance tobacco taxation enforcement and compliance, and minor changes to the duty on certain tobacco products.

Administrative Changes

Late remittance of source deductions — For late remittances of source deductions that are due on or after February 26, 2008, the current 10% fixed penalty is replaced with a graduated penalty regime of:

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

Aboriginal tax policy — To date, the government has entered into 30 sales tax and 13 income tax arrangements with self-governing Aboriginal groups under which the groups impose a sales or personal income tax within their reserves or settlement lands. In the 2008 budget, the government reiterates its willingness to discuss and put into place direct taxation arrangements with interested Aboriginal governments.

We can help

Your KPMG adviser can help you assess the effect of the tax changes in this year's budget on your personal finances or business affairs, and point out ways to take advantage of their benefits or ease their impact. We can also keep you abreast of the progress of these proposals as they make their way into law and help you bring any concerns you may have to the attention of the Ministry of Finance.