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TAX PERSPECTIVES

A PUBLICATION OF THE TAX SPECIALIST GROUP (TSG)

www.taxspecialistgroup.ca

SPECIAL BUDGET COMMENTARY

March 19, 2007 Federal Budget

Spring 2007

VOLUME VII NUMBER 2

Overview

In delivering his first full budget, Finance Minister Flaherty has produced a series of initiatives, tax incentives, and get-tough measures, which are hard to criticize. In doing so, he has thrown down the gauntlet to the opposition parties to either approve his minority government's budget, or face an election. While being careful not to give away too much, this budget will certainly be pleasing to majority of stakeholders, individuals and Canadian private business in particular.

The Budget contains tax relief for low-income families, further assistance in saving for retirement and education, income-splitting benefits for pensioners, and increases in personal exemptions. It proposes to increase the $500,000 capital gains exemption to $750,000. Also, the government will proceed with reducing corporate tax rates, and a further minor reduction is proposed for 2011.

In a surprise move, machinery and equipment will be eligible for incentive depreciation for a limited period of time. Also, the depreciation rate on non-residential buildings will be increased from 4% to 6%, in general, and to 10% for buildings used in manufacturing and processing, for purchases after budget date.

In the international area, there is good news and bad news. The good news is that changes will be made to the Canada-U.S. Treaty to bring limited liability companies (LLC's) within the Treaty, and reduce the withholding tax on interest from 10% to nil. This is part of a broader strategy to enhance Canada's competitiveness in global capital markets.

Now the bad news. Interest on Canadian borrowings used to finance foreign corporations will cease to be deductible. Canadian shareholders of foreign corporations established in non-treaty countries (e.g., tax havens) will be taxed punitively unless the jurisdiction enters into a tax information exchange agreement with Canada. However, if it does, significant benefits will result.

If one were to criticize this budget, it would be for what it does not contain.

Canadian individuals might have been hoping for a reduction in personal income tax rates. This is particularly difficult in a federal/provincial tax system because of the temptation for provinces to increase personal income tax rates to take up the federal reduction. Nevertheless, the top Canadian personal income tax rate is significantly higher than in the U.S. or the U.K. (although rates do vary by province). Also, there was a rumour of capital gains relief and possibly an initiative to allow capital gains tax to be deferred if a replacement property was purchased. We have seen no reduction in capital gains rates, nor is there an expansion of the current capital gains deferral rules for replacement properties.

Lastly, it was widely hoped that we would see an enhancement of the tax incentives for research and development. The Budget is silent on this. We can only hope then that some goodies are being saved intentionally for 2008.

Individuals

This is an area of new ideas and returns to earlier eras.

To effect equality between the single-income family and the two-income family, the personal tax credit for a spouse has been raised to equal the individual exemption credit. For 2007, this is $8,929. However, income-splitting is still of value due to progressive tax rates so that a two-income earning family still has a tax advantage.

For almost a generation, no tax relief has been given to families other than low-income families for dependent children under age 18. Now, at $2,000 per child, the federal tax credit at 15.5% will provide the family with $310 of tax relief per child. A provincial tax saving should also result. This measure yields over half of the total benefit given to Canadians in tax relief by the 2007 Federal Budget.

Another flashback: RRSPs may now remain until the individual attains 71 years of age. If a RRIF has already been established and the individual turns 70 or 71 years of age in 2007, then the minimum withdrawal is waived while the individual is aged 71 or under.

The registered education savings plan is also returned to its past rules. Effective for 2007, there is no annual maximum contribution, only a lifetime limit of $50,000 (increased from $42,000). This can help the family with a last minute need to fund post secondary education. The federal grant portion has been increased from $400 to $500 per year.

To broaden the fairness of exempting scholarships from tax, elementary and secondary school scholarships will also be exempted from 2007 onwards.

Qualified investments for RRSP's will be expanded to include most investment grade debt and publicly listed securities.

There are no reductions in tax rates, but a continuance of the idea of many different tax credit incentives for such things as municipal transit and child fitness.

Businesses

The Budget continued with the corporate tax rates that were proposed in the 2006 Budget. The only additional change is to further reduce the general tax rate in 2011 to 18.5%.

Tax Rates

The table below outlines the proposed reductions in federal tax rates from 2007 to 2011.

	2007	2008	2009	2010	2011
Small business	13.12	11.15	11.0	11 0	11.0
General	22.12	20.50	20 0	19 0	18 5

Capital Cost Allowance (CCA) Rates

Currently, manufacturing and processing (M&P) equipment can be depreciated on a declining balance method at a rate of 30% per year. The Budget proposes to temporarily allow an accelerated CCA deduction for eligible M&P machinery and equipment at a rate of 50% on a straight-line basis, subject to the half-year rule. This would mean that in Year 1, the maximum CCA deduction would be 25%; in Year 2, the maximum deduction would be 50%; and in Year 3, the maximum deduction would be 25%. This will apply for all M&P machinery and equipment purchased after March 19, 2007 and before 2009. This is a significant incentive to businesses to purchase eligible machinery and equipment.

The Budget also proposes to increase the CCA rate for buildings used in manufacturing and processing as well as other non-residential buildings and computers. See the table below for the changes to the rates.

Asset	Current Class	Current Rate	New Rate
Buildings used for manufacturing and processing	1	4%	10%
Other non-residential buildings	1	4%	6%
Computer equipment	45	45%	55%

The increased rates will apply to eligible property acquired on or after March 19, 2007.

Instalments

At present, Canadian-controlled private corporations (CCPC's) must make instalments on a monthly basis. The Budget proposes to allow "eligible CCPC's" to make quarterly instalments for taxation years that begin after 2007. A CCPC is an "eligible CCPC" if:

1. The taxable income of the corporation for either the current or previous year does not exceed $400,000;
2. The corporation qualified for the small business deduction for either the current or previous year;
3. The taxable capital employed in Canada of the corporation does not exceed $10 million in either the current or previous year; and
4. The corporation has filed all returns under the Income Tax Act and Excise Tax Act in the last 12 months as well having paid all taxes related to GST, employment insurance, Canada Pension Plan, and income tax for the last 12 months.

continued on page 4

Capital Gains

Leading up to this Budget, there was much discussion as to the deferral reduction or elimination of capital gains. This did not happen. Instead, the Budget focuses on the incentives for sale of certain private company shares as well as the donation of public company shares.

Capital Gains Exemption

The capital gains exemption is available to individuals who sell qualified small business corporation (QSBC) shares and qualified farm and fishing property. In general terms, QSBC shares are shares in a Canadian-controlled private company where the company uses at least 90% of its assets to earn active business income at the time of the sale and so used at least 50% of its assets during the 24 months before the sale. The Budget proposes to increase the capital gain eligible for the capital gains exemption from $500,000 to $750,000.

There are a number of small business owners who have crystallized the $500,000 capital gains exemption in the past. These new rules allow for an additional crystallization of $250,000. A careful review of all corporate structures should be undertaken to ensure that the shareholders take advantage of the maximum amount of capital gains exemption available to them.

Gifts to Private Foundations

In last year's budget, the government introduced new rules allowing for the donation of public company shares to a public foundation on a tax-free basis. This resulted in significant donations to non-profit institutions across the country. To further encourage charitable giving, the 2007 Budget extends the exemption of capital gains tax on gifts of public company shares to private foundations on or after March 19, 2007. A similar exemption applies to exempt stock option benefits where the stock is donated to a private foundation within 30 days of exercise. These exemptions have been made available with the introduction of "excess business holdings" rules so as to limit the shareholdings that a private foundation can hold, taking into account the holdings of persons who do not deal at arm's length with the foundation.

International

The Budget contains a surprisingly long list of international measures, many of which have been laid out in great detail.

U.S. Limited Liability Companies (LLC's)

It has become increasingly common for U.S. businesses to invest in Canada through LLC's. Also, Canadians doing business in the U.S. frequently use LLC's. Sometimes this is the only vehicle available to them. Because LLC's are, in general, not taxable entities in the U.S. (rather, the income is assessed to the owner of the LLC, and not the LLC itself), various complications arise for Canadian tax purposes. Firstly, LLC's currently do not get the benefit of the Canada-U.S. Treaty. This means that the withholding tax rate on payments from Canada to a U.S. LLC may be 25%, instead of the rate provided under the Treaty (5% or 10% would be typical). Secondly, U.S. LLC's are subject to capital gains tax in Canada where a U.S. individual or a U.S. corporation would be exempt. The list of other complications and problems is extensive.

Under the budget proposals, Canada will move to amend the Canada-U.S. Treaty to recognize U.S. LLC's for treaty benefits. This will eliminate the problems above, make LLC's more attractive to Canadians, and make Canadian investments more suitable for U.S. LLC's.

Withholding Tax on Interest

To make the Canadian financial marketplace more competitive internationally, all withholding on interest payments between Canada and the U.S. will be eliminated. Canada will also move to exempt from withholding tax all arm's length interest payments to non-residents.

Foreign Corporations

Canadian corporations that have international subsidiaries are currently subject to a complex series of rules when profits are repatriated to Canada. If the foreign subsidiary carries on an active business, no tax is paid in Canada until funds are repatriated by way of dividends. Then, if the foreign affiliate carries on business in a country with which Canada has an international tax treaty, the dividend received by the Canadian parent company will be tax-free. Otherwise, the dividend is taxable at that time.

Canadian companies frequently borrow in Canada to invest in shares of foreign subsidiaries. The interest is deductible in Canada, even though dividends received in the future may be exempt of tax. It is proposed that this advantage be eliminated for arm's length borrowings after 2009, and for existing arrangements that are non-arm's length after 2008. For new borrowings made on or after March 19, 2007, the interest will be non-deductible commencing in 2008.

Industrialized countries are becoming increasingly concerned with the proliferation of tax havens, particularly where secrecy is involved. Accordingly, Canada will move to deem all income earned in a non-treaty country to be passive income, regardless of its actual nature, unless such a country has entered into an international tax treaty or a Tax Information Exchange Agreement (TIEA). This may cause a

continued on page 4

Businesses continued from page 2

For those corporations that qualify, the quarterly instalments will be due on the last day of each quarter of the corporation's taxation year. For those corporations eligible to pay quarterly but do not remit the instalment when due, they will be required to make monthly payments. This does not affect the balance due date for any corporate income taxes.

International continued from page 3

Canadian shareholder to have to report the income even if it has not been received. Countries will be given at least five years to enter into a TIEA once negotiations start. However, if the agreement is not concluded by that time, then the new passive income rule will start to apply.

While this measure has a big stick associated with it, it also comes with a carrot. If a country does enter into a TIEA, then active business income will be considered to be exempt surplus, eligible for tax-free repatriation to a Canadian corporate shareholder in certain cases.

A number of tax havens have already entered into information exchange agreements with countries such as the U.K. and the U.S. It is to be expected that such countries and others will readily enter into such agreements with Canada. This will create a new landscape in the international arena, allowing Canadian companies the ability to set up subsidiaries in countries with no income tax (e.g., possibilities may include Bermuda, the Bahamas, and the Cayman Islands), while enjoying the ability to repatriate funds to Canada free of tax. At present, this privilege is limited to tax treaty countries where, with the notable exception of Barbados, the tax rate will be 10% or higher.

Foreign Investment Entity Rules

Lastly, draft legislation containing amendments to the taxation of non-resident trusts and foreign investment entities (FIE's) was released in 2006, with these rules to become applicable in 2007. The rules were originally to apply commencing January 1, 2003 and had their origin in the 1999 Federal Budget. These measures are still pending. At the conclusion of the budget documents there is a list of measures that the government intends to pursue. These rules are not included in the list. Also, any objective analysis of the FIE rules will readily conclude that these rules penalize Canadians wishing to invest in foreign investment markets, particularly through foreign mutual funds. It is therefore possible that the government may be reconsidering whether to move forward with these rules. On this, we will have to wait and see (and hope).

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