GGFL FEDERAL BUDGET COMMENTARY

February 26, 2008

BUDGET OVERVIEW

Federal Finance Minister Jim Flaherty showed clearly in his third Budget that the government has no intention of rocking the economic boat when it comes to introducing new measures or modifying existing ones. Much of the Budget, tabled on February 26, 2008, proposes adjustments to existing tax programs while re-asserting the government's commitment to reduce debt and encourage saving among individual Canadians.

To this end, the Minister proposes to reduce the taxation of savings through a registered Tax-Free Savings Account to which Canadians can contribute as much as $5,000 a year, beginning in 2009. (Details of the Budget are discussed later in this report.)

While the Minister announced no new tax credits or changes to personal tax rates, the Budget proposes some minor tax relief in the form of adjustments to Registered Education Savings Plans, Medical Expense Credits and Registered Disability Savings Plans. The Minister also proposed a 10-year extension of the age limit on RESPs, to 31 years from 21, and a 10-year extension of contribution years, as well.

For Canadian businesses, the Budget offers several measures to support the manufacturing sector, in which real output has declined by 3.4% in the last two years, and to encourage innovation among small and mid-sized businesses. The Budget proposes to extend accelerated capital cost allowance treatment for investment in machinery and equipment for three years, for example, a measure intended to provide Canada's manufacturing and processing sector with about $1 billion in tax relief. It also includes improvements to the scientific research and experimental development tax incentive program.

The Budget also proposes to create a new Crown corporation in 2009 that will implement a new EI premium rate-setting mechanism. Another proposed Crown corporation, PPP Canada Inc., will work with the private and public sectors to support public-private partnerships. The Budget also proposes to make permanent the federal Gas Tax Fund, which will contribute $2 billion in 2009/10 to supporting long-term municipal infrastructure improvements. And it provides $500 million in support of capital investments for enhancing public transit.

PERSONAL

Dividend Tax Credit (DTC)
The DTC compensates the individual shareholder for corporate-level tax in order to integrate the personal and corporate tax systems at the federal level. "Eligible dividends" were introduced in 2006 and are subject to a higher gross-up and an enhanced DTC in order to recognize that these dividends are generally paid out of income taxed at a higher rate.

The 2007 Economic Statement will reduce the general corporate tax rate to 15 per cent by 2012. It stated that adjustments would be considered to the enhanced DTC to ensure the appropriate tax treatment of eligible dividends. The Budget proposes to adjust the dividend gross-up and DTC for eligible dividends to reflect these corporate tax rate reductions. The gross-up of eligible dividends will be reduced from 45 per cent to 44 percent effective January 1, 2010, 41 per cent effective January 1, 2011, and 38 per cent effective January 1, 2012. The enhanced DTC will also change on the same schedule from 11/18 of the gross-up amount to 10/17, 13/23 and 6/11.

The intention is that the net after-tax dividend should remain approximately the same. However, where it is desirable to defer the payment of dividends along with the related personal tax to a subsequent year, the individual recipient will be worse off.

Tax-Free Savings Account (TFSA)
The Budget proposes a TFSA, a registered account that individuals will be able to utilize for their savings. Commencing in 2009, Canadian residents, age 18 or over, will be able to contribute up to $5,000 annually (indexed annually after 2009) to a TFSA. Any portion of this $5,000 annual contribution limit not utilized in one year can be carried forward indefinitely to a future year. Any amounts withdrawn from the TFSA in a year will be added to the individual's limit in the following year. Any excess contributions over the available limit will be subject to a penalty tax of one per cent per month.

Although contributions to the TFSA will not be deductible for income tax purposes, the investment income earned within the TSFA will not be taxable. Withdrawals can be used for any purpose and will not be subject to tax or taken into account in determining eligibility for income-tested benefits or credits such as the age credit or Old Age Security benefits.

Interest on money borrowed to invest in a TFSA will not be tax deductible. However, unlike RRSPs, individuals will be allowed to use their TFSA assets as collateral for a loan.

The income attribution rules will not apply to funds borrowed by a spouse or common-law partner to invest in his/her TFSA.

A TFSA will lose its tax-exempt status upon the death of the individual. Consequently, investment income and gains that accrue after the individual's death will be taxable. However, an individual will be permitted to name his/her spouse or common-law partner as the successor account holder, in which case the account will maintain its tax-exempt status. Alternatively, the assets of the deceased's TFSA may be transferred to a TFSA of the surviving spouse or common-law partner.

An amount may also be transferred on the breakdown of a marriage or common-law partnership directly from the TFSA of one party to the TFSA of the other party. This type of transfer will not reinstate the contribution room of the transferor and will not reduce the contribution room of the transferee.

An individual who becomes a non-resident of Canada will be allowed to maintain his/her TFSA, which will continue to be exempt from tax. However, contributions will not be allowed while the individual is a non-resident and contribution room will not accrue for any year throughout which the individual is a non-resident.

The Canada Revenue Agency (CRA) will determine TFSA contribution room based on tax returns filed. Individuals who have not filed tax returns in prior years will be permitted to establish their entitlement by filing such returns or by other means acceptable to CRA.

Financial institutions eligible to issue RRSPs will be permitted to issue TFSAs. TFSA issuers will be required to file annual information returns to report the value of an account's assets at the beginning and the end of the year, as well as the amount of contributions, withdrawals and transfers made in the year.

A TFSA will generally be permitted to hold the same investments as an RRSP. However, a TFSA will not be allowed to hold investments in any entity with which the individual does not deal at arm's length, including an entity of which the individual is a "specified shareholder" (generally a 10 per cent or greater interest).

Registered Education Savings Plan (RESP)
A RESP must currently be terminated by the end of the year that includes the 25th anniversary of the opening of the plan unless the beneficiary of a single-beneficiary RESP qualifies for the Disability Tax Credit. In addition, contributions may not be made to a family plan for a beneficiary who is 21 years of age or older.

The Budget proposes to increase the time limits by an additional10 years for 2008 and subsequent taxation years.

RESP beneficiaries are eligible to receive Educational Assistance Payments (EAPs) from the plan if they are enrolled in a qualifying program at the time. The Budget

proposes to allow RESP beneficiaries to receive EAPs for six months after ceasing to be enrolled in a qualifying program after 2007.

Registered Disability Savings Plans (RDSPs)
The Government is working with financial institutions to put the necessary mechanisms in place to allow them to offer RDSPs in 2008.

If a RDSP beneficiary ceases to be eligible for the Disability Tax Credit, the current RDSP rules require that the proceeds of the plan be paid out to the beneficiary and the plan collapsed. There is a concern that this requirement could, contrary to the wishes of the parent, enable the beneficiary to rescind his/her Disability Tax Credit certification and gain full access to the funds.

Consequently, the Budget proposes to provide instead for a mandatory collapse of the plan only when the beneficiary's condition has factually improved to the extent that the beneficiary no longer qualifies for the Disability Tax Credit.

This proposal will be effective for 2008 and subsequent taxation years.

Medical Expense Tax Credit
The Budget proposes to extend the tax credit to the cost to purchase, operate and maintain the following devices prescribed by a medical practitioner:
- altered auditory feedback devices for treatment of a speech disorder;
- electrotherapy devices for the treatment of a medical condition or severe mobility impairment;
- standing devices for standing therapy in the treatment of severe mobility impairment, and
- pressure pulse therapy devices for the treatment of a balance disorder.

The Budget proposes to extend eligibility for the cost of service animals specially trained to assist individuals who are severely affected by autism or epilepsy.

The above additions to the list of eligible expenses will be effective for 2008 and subsequent taxation years.

The Budget proposes to clarify that, effective for expenses incurred after February 26, 2008, eligible drugs and medications must be purchased with a prescription.

Northern Residents Deduction
Individuals who live in prescribed areas in northern Canada for at least six consecutive months may claim the northern residents deduction. The deductible amount varies depending upon where the individual lives. The Budget proposes to increase this deduction by10 per cent for 2008 and subsequent taxation years.

Mineral Exploration Tax Credit

The mineral exploration tax credit is a benefit, in addition to the deduction of Canadian exploration expenses, equal to 15 per cent of specified mineral expenses incurred in Canada and renounced to the shareholders. The Budget proposes to extend eligibility for this credit to flow-through share agreements entered into by March 31, 2009, which can support eligible exploration until the end of 2010.

BUSINESS TAX MEASURES

Scientific Research and Experimental Development (SR&ED)

Under the current system, Canadian-controlled private corporations (CCPCs) are entitled to a tax credit or a cash refund of investment tax credits (ITCs) based on the following formula:

Amount of expenditure	ITC Rate	Refund of ITC
First $2,000,000	35%	100%
Amount over $2,000,000	20%	40%

Eligibility for the 35% rate is phased out if the corporate group's taxable capital (as calculated for Large Corporation Tax purposes) exceeds $10 million and/or if the corporate group's taxable income exceeded $400,000 in the preceding taxation year.

The Budget proposes to increase both the expenditure limit eligible for the 35% rate and the phase-out ranges for taxation years that end on or after February 26, 2008 (subject to proration for straddle years):

	Current	Proposed
Taxable income from $400,000 to	$600,000	$700,000
Taxable capital in excess of $10 million	$15 million	$50 million

Due to the increase in the expenditure limit to $3,000,000, a corporation may now receive a $1,050,000 refund versus the current maximum of $700,000.

The new phase-out limits, like the old ones, are prorated for short years.

SR&ED Carried on Outside of Canada

A taxpayer cannot currently claim an ITC for SR&ED expenditures carried on outside Canada. The Budget proposes that certain salaries or wages incurred outside of

Canada (“foreign salaries”) on or after February 26, 2008, (subject to proration for straddle years) will be eligible for ITCs. More specifically:

- The taxpayer must directly undertake the activities outside of Canada solely in support of SR&ED that the taxpayer carries on in Canada.
- Foreign salary eligibility is limited to 10% of the total salaries and wages incurred.
- Foreign salaries will not include salaries and wages based on profits or bonus or salary or wages subject to tax in the foreign country.

Administrative Measures
In order to facilitate ITC claims, the CRA will:

- introduce a new SR&ED claim form and guide and eligibility-assessment tool;
- review policies and procedures to ensure they are aligned with current business practices and are applied consistently across the country, and
- invest an additional $10 million to administer the program.

Manufacturing and Processing (M&P): Accelerated Capital Cost Allowance (CCA)
Generally, qualifying M&P equipment would be included in Class 43, which is a 30% declining balance class. The 2007 Budget provided that qualifying equipment acquired before 2009 would go into Class 29, a 50% straight-line class. The Budget extends this qualifying period to assets acquired in 2009.

Eligible assets acquired in 2010 and 2011 will be included in Class 43 but the CCA rate will be subject to special transitional rules:

Year Acquired	2010	2011	Thereafter
2010	50%	40%	30%
2011	40%	30%	30%
Thereafter	30%	30%	30%

Assets acquired in 2010 and 2011 will be placed in separate Class 43 pools. After 2011, the separate pools will be merged.

All the above measures are subject to the half-year rule.

Clean Energy Generation: Accelerated CCA
Class 43.2 allows 50% CCA to be claimed on a declining balance basis. Eligibility for Class 43.2 has been expanded to include:

- qualifying Ground Source Heat Pump Systems;
- additional feedstocks for Biogas Production Equipment, and
- equipment used to produce heat from waste sources and equipment used to produce bio-oil.

Remittance of Source Deductions
Currently there is a penalty of 10 per cent for any late remittance of source deductions. This penalty is increased to 20 per cent when the failure to remit is made knowingly or in circumstances amounting to gross negligence. The Budget proposes to enact a graduated penalty regime for remittances due after February 26, 2008, as follows:

- 3 per cent if the remittance is one to three days late;
- 5 per cent if the remittance is four or five days late;
- 7 per cent if the remittance is six or seven days late, and
- 10 per cent if the remittance is more than seven days late.

Currently withholdings must be remitted directly to a financial institution in order to avoid late remitting penalties. The Budget proposes to allow withholdings due on or after February 26, 2008, to be remitted directly to the CRA, without penalty, as long as the remittance is received at least one full day before the due date.

Business Number (BN) Initiative
As part of the government's initiative to reduce the paper burden on small business, the Budget proposes the following:

- broaden the scope of the BN-related information that may be shared with BN Partners to include a range of relevant contact, identification and status information;
- expand the type of government entities that qualify as BN Partners to include other levels of government in Canada such as municipalities and Aboriginal governments, and
- allow for the publication of the BN by BN Partners in connection with programs or services provided by the BN Partner.

Since privacy issues must be considered, the CRA will be precluded from sharing any personal information naming individuals except where it relates to a business activity. In any case, only the business name and business number may be released to the public. All other BN-related information will be available only to BN Partners. The legislation to implement this measure will be developed in consultation with the Office of the Privacy Commissioner.

Publicly traded trusts
Publicly traded income trusts and partnerships (SIFTs) are generally subject to a special tax on distributions. (SIFTs that existed on October 31, 2006, are subject to grandfathering rules which eliminate this tax until 2011.) The tax is comprised of a federal element (reduced to 15% by 2012 in step with the federal corporate rate reduction) and a provincial element (currently 13%).

For 2009 and subsequent taxation years, the provincial element will be computed differently. Distributions will be allocated to the provinces in accordance with the corporate taxable income allocation formula in the regulations. The various provincial

corporate rates will then be applied to such allocations to arrive at a composite rate. Distributions not allocated to a province will be taxed at 10%. Distributions allocated to Quebec will not be subject to this provincial element because Quebec imposes its own tax.

DONATIONS

Donations of Exchangeable Securities

Currently, a taxpayer donating publicly traded securities to a registered charity or other eligible donee is entitled to a significant tax benefit. Notwithstanding the fact that the excess of the fair market value (FMV) over the tax value of the donated security is not taxed, the taxpayer is credited with a donation equal to that FMV.

The Budget proposes to extend this benefit to donations, made on or after February 26, 2008, of publicly traded securities acquired in exchange for unlisted securities, if the following conditions are met:

- The securities can be shares or partnership interests.
- At the time of issue, the securities must have been subject to a condition allowing them to be exchanged for publicly traded securities.
- The publicly traded securities must be the only consideration received on the exchange.
- The publicly listed securities so acquired must be donated to a registered charity or other qualified donee within 30 days after the exchange.
- Where the unlisted security is a partnership interest, the portion of the gain arising from a cost base reduction due to losses will be taxed.

Private Charitable Foundations

Private foundations are restricted regarding the percentage of the shares of any class of a corporation that they can own.

- The foundation can own up to 2% without restriction.
- If the foundation, along with non-arm's-length persons, owns more than 20% (the "20% limitation"), the foundation must divest itself of shares so that either its own shareholdings fall to 2% or less or the 20% limitation is met. (For shares held on March 18, 2007, the 20% limitation is subject to an exemption for shares that the donor required the foundation to retain and are subject to grandfathering rules.)

Generally for taxation years commencing on or after March 19, 2007, the Budget proposes to exempt unlisted shares held on March 18, 2007, from these restrictions. The Budget also proposes to broaden certain anti-avoidance rules to make it more difficult to avoid the restrictions.

Donation of Medicines

The 2007 Budget introduced an incentive for corporations to donate medicines for international use by providing for an additional special deduction. In order for the corporation to qualify for this deduction currently, the donee must be a registered charity that has received a disbursement under the Canadian International Development Agency (CIDA) and the gift is made for activities outside Canada. The Budget proposes to change the definition of an eligible charity to one that, in the opinion of the Minister of International Cooperation, meets the conditions prescribed by regulation. This change is being proposed in order to ensure that the eligible charities act in a manner consistent with the World Health Organization Guidelines, have expertise in delivering medicine to the developing world, and implement policies and practices with respect to the delivery of international development assistance. Eligible gifts must be donated at least six months prior to the expiry date of the medicines. These proposed changes apply to medicines donated on or after July 1, 2008.

INTERNATIONAL

Section 116 Certificates

When a non-resident disposes of "taxable Canadian property" (TCP), unless the vendor has obtained a certificate under section 116 of the Act, the purchaser must withhold and remit a portion of the proceeds to the CRA on account of the non-resident's possible Canadian income tax liability. If the purchaser fails to follow these procedures, the purchaser then becomes liable for the tax. The current system is cumbersome, inefficient and does not take into account gains that are exempt under tax treaties. The Budget proposes to eliminate the need for a Section 116 Certificate after 2008 if:

- the disposition of the TCP by the non-resident is a treaty-protected property, or
- the purchaser, after reasonable inquiry, concludes that the TCP is treaty-protected and that the vendor was resident in that treaty country.

In the first case, a related purchaser must report the transaction to the CRA within 30 days of the disposition. In the second case, all purchasers must report the transaction to the CRA within 30 days after the disposition.

If no Canadian taxes are payable by the non-resident, the vendor may not have to file a Canadian tax return to report the disposition.

PREVIOUS MEASURE NOT YET ENACTED

Draft section 3.1 of the Income Tax Act was first introduced on October 31, 2003, to be effective for taxation years commencing after 2004. The provision was intended to legislate a "no reasonable expectation of profit" rule. It would have had a particularly harsh impact on interest deductibility in many circumstances.

In response to harsh criticism from the tax community and others, the provision is being reviewed by Finance. The Budget makes no mention of the provision. It is not clear when it will be reintroduced, what changes will be made to it and what its effective date will be.

SALES, EXCISE TAX AND OTHER MEASURES

GST/HST Health Measures
Effective February 27, 2008, the Budget will extend GST/HST exempt status to a range of health care services, prescription drugs and medical devices.

GST/HST exempt status will apply to supplies of specially designed training to assist individuals to cope with a disability or disorder if:

- the training is supplied by a government;
- the cost of training is fully or partially reimbursed under a government program, or
- a health professional whose services are GST/HST exempt prescribes the training to allow the patient to better cope with the disability or disorder.

Effective February 27, 2008, nursing services rendered to a patient by a registered nurse, a registered nursing assistant, a licensed or registered practical nurse or a registered psychiatric nurse will be exempt from GST/HST regardless of where the service is performed.

All supplies of drugs to final consumers will be zero-rated when they are prescribed by health professionals who are authorized to prescribe such drugs under provincial or territorial legislation. The zero-rating is effective for all supplies made after February 26, 2008, as well as supplies made on or before February 26, 2008, if the GST/HST was neither charged nor collected.

Effective February 27, 2008, the following medical and assistive devices are zero-rated:

- devices for neuromuscular stimulation or standing therapy prescribed by a medical practitioner;
- chairs for use by individuals with a disability prescribed by medical practitioner;
- chest wall oscillation systems for use in airway clearance therapy, and
- service animals supplied by recognized organizations that are trained to assist individuals with a disability or impairment.

GST/HST Treatment of Long-Term Care Facilities
The Budget clarifies the GST/HST treatment of long-term residential care facilities to ensure the GST New Residential Rental Property Rebate and GST/HST exempt status will apply to such facilities on going forward basis.

The current exemption for residential units supplied to individuals will be replaced with a requirement that possession or use of the residential units be given to individuals for the purpose of their occupancy as a place of residence. This relieving provision may also apply to transactions on or before February 26, 2008, when specific legislative requirements have been met.

GST/HST Treatment of Property Leases for Wind and Solar Power Equipment
Effective February 27, 2008, GST/HST will not apply on payments for a supply of a right of entry or use to generate or evaluate the feasibility of generating electricity from the sun or wind. This proposal also applies to supplies made under such arrangements before February 26, 2008, but only with respect to amounts that become payable subsequent to February 26, 2008.

Tobacco Excise Duties
The Budget proposes a number of changes to enhance tobacco taxation enforcement and compliance:

- possession and importation of tobacco manufacturing equipment will be limited to persons holding a licence to manufacture tobacco products;
- all manufactured tobacco of 50 grams or less will be subject to duties applicable to 50 gram packages;
- the rate of duty on tobacco sticks will be increased effective February 27, 2008, to equate to the rate applied on cigarettes, and
- the current rule allowing Canadian producers of tobacco products to pre-pay the duty on tobacco intended for sale at duty free shops will be extended to foreign producers.

Excise Duty on Imitation Spirits
Imitation spirits derived from a brewing process will now have varying excise duty treatment based on their alcohol content. Previously all such spirits received the favourable excise duty treatment afforded beer. Effective February 27, 2008, imitation spirits having an alcohol content of 11.9% or less will continue to be taxed in a manner similar to beer. However, when the alcohol content exceeds 11.9% imitation spirits will be taxed in the same manner as regular spirits (excise duty of $11.696 per litre of absolute alcohol). Additionally, producers and importers of imitation spirits with an alcohol content above 11.9% will be required to operate under a spirits rather than beer licence.