

## Federal Budget 2007

March 19, 2007

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This brief is one in a series on tax-smart investing. We believe you'll find this brief, along with our tax-smart investment products, helpful in maximizing the value of your taxable investment portfolio.

## BUDGET 2007 – A Stronger, Safer, Better Canada

The 2007 Federal Budget, *“Aspire to a Stronger, Safer, Better Canada,”* is the second for Finance Minister James Flaherty and Prime Minister Stephen Harper's minority Conservative government.

The key tax changes in this budget are aimed at families and businesses, and are found under the budget's headings for a “better” and “stronger” Canada. For the investment community, the government has put forth a plan in the budget dealing with stronger and more vibrant capital markets for Canadians.

The “safer” aspect of the budget deals with government objectives for making Canada and the world a safer place to live – including funding for the Canadian forces, a national anti-drug strategy, combating criminal use of firearms, combating sexual exploitation of children, and fighting white-collar crime. Apart from the funding for the Canadian forces over the next three years, the amounts allocated to the other Canadian initiatives listed above are, unfortunately, nominal. On the other hand, funding for international initiatives is more significant, including Afghanistan objectives and vaccines for the world's poor.

In terms of the Minister's overall outlook on the Canadian economy:

- growth in 2007 and 2008 is forecast to be 2.3% and 2.9%, respectively
- employment remains strong, notwithstanding that the country's economic growth has cooled recently, which has still left consumers and businesses confident, and
- the risks to the economy are slow domestic productivity growth, rising oil prices, and a downturn in U.S. consumer demand.

At the same time, the government plans to reduce the federal debt by \$10.2 billion in fiscal 2006-07 and stay on target to lower the federal debt-to-GDP ratio to 25% by fiscal 2012-13. The “Tax Back Guarantee” – to be legislated by this budget – will direct \$1 billion a year in debt interest savings to personal income tax reductions. The government remains committed to reviewing departmental spending so that Canadian taxpayer money is spent efficiently.

We'll now turn our attention to addressing the personal and business tax changes in this budget.

### Personal Tax Measures

The following are measures that impact individuals and their personal tax liability:

#### **New Child Tax Credit**

A new non-refundable child tax credit for all parents is based upon the amount of \$2,000 (indexed) for each child under age 18 at the end of a tax year, and is calculated using the lowest personal income tax rate (15.5%).

Effective for 2007, this incentive offers tax relief up to \$310, is transferable by a parent to his/her spouse or common-law partner, and is fully available for the year of birth, adoption, or death of a child.

There will be no income limitation or clawback to this new child tax credit.

#### **No Personal Tax Rate or Personal Amount Changes**

There are no changes in the budget to personal income tax rates, or the basic personal amount.

#### **Increasing Personal Income Tax Instalment Threshold to \$3,000**

Under existing tax rules, many Canadians, including self-employed persons and seniors, are required to make quarterly tax instalment payments. These payments cover their income taxes where estimated income tax payable (federal/provincial) for the current year, or actual tax payable for either of the two preceding tax years, exceeds the amount withheld at source for those years by an amount that's greater than \$2,000 – the instalment threshold amount.

The 2007 budget proposes to increase the instalment threshold amount to \$3,000 (\$1,800 for Quebec residents). This change also applies to self-employed persons whose main source of income is from fishing or farming. However, the balance due date for taxes payable for any tax year remains April 30 of the following tax year.

This proposed change is for instalments in 2008 and later tax years. The Canada Revenue Agency (CRA) will continue to notify individuals required to remit instalments of the amount of each instalment based upon CRA's tax information.

#### **Spousal and Other Amounts**

The basic personal amount represents the income any Canadian resident can earn before being subject to income tax. For 2007, the basic personal amount is \$8,929. There's also a credit available in respect of a spouse or

common-law partner, or wholly dependant relative, in the amount of \$7,581 for 2007. This additional amount (the credit calculation) is reduced for each dollar of income of the dependant above a threshold of \$759 (in 2007).

The budget proposes to increase the amount by which this dependant credit is calculated by \$1,378 (thereby matching the basic personal amount of \$8,929) for 2007, while eliminating the threshold above which the dependant net income must be taken into account. Notwithstanding the increase to the dependant amount, the elimination of the threshold amount means a grind to the dependant amount for each \$1 of income now – not just that in excess of \$759.

For 2008 and later years, these personal credit amounts will be increased by the same amounts that are effective for the basic personal amount. In 2008, the basic personal amount is increased by indexation – plus \$200 – and, for 2009, it's increased by indexation, plus the greater of \$600 and the amount required to raise these amounts to \$10,000.

#### **Public Transit Pass Tax Credit Enhancements**

This budget strengthens the non-refundable federal tax credit available for the cost of public transit travel on buses, streetcars, subways, commuter trains, and local ferries. Allowable costs now will include electronic payment cards and weekly passes. Again, taxpayers making claims should retain receipts for verification purposes.

This measure will apply to the cost of electronic payment cards and weekly passes after 2006.

#### **Lifetime Capital Gains Exemption and other Capital Gains**

Currently, the lifetime capital gains exemption is available on up to \$500,000 of qualifying property (farm and fishing, and qualified small business corporation shares). The budget proposes to increase this exemption to up to \$750,000 of capital gains realized by an individual on qualified properties.

This change will apply to dispositions or transfers of qualified property that take place on or after March 19, 2007.

This budget didn't contain the anticipated deferral of capital gains taxes on the sale of assets when the proceeds are reinvested within six months.

#### **Elementary and Secondary School Scholarships**

As a measure intended to benefit students, scholarships to attend elementary and secondary schools – which are

currently included in the student's income (if the amount exceeds \$500) – are to be eliminated from taxation.



### Registered Education Savings Plan (RESP)

This budget proposes several measures to provide more flexibility to families saving for a child's education with an RESP. This flexibility comes in the following forms:

- The annual \$4,000 contribution limit will be eliminated, and the lifetime RESP contribution limit will be increased to \$50,000 from \$42,000.
- The maximum annual RESP contribution qualifying for the 20% Canada Education Savings Grant (CESG) will be increased to \$2,500 from \$2,000 (a maximum CESG per beneficiary now will be \$500, up from \$400). Likewise, if there's unused grant room because of lower than maximum contributions in prior years, the maximum CESG rises to \$1,000 from \$800.

Unfortunately, there will be no increase to the \$7,200 lifetime CESG limit.

Although the budget proposes these changes apply to contributions after 2006, the CESG entitlement on the increased CESG limit only will be paid once Royal Assent is given to the implementing legislation, and once delivery systems to accommodate the changes are put in place.

The budget also proposes to relax the Education Assistance Payments (EAP) requirement to accommodate part-time studies that don't meet the 10 hours per week requirement, but which require at least 12 hours per month. Accordingly, students age 16 and over will be able to receive up to \$2,500 of EAPs for each 13-week period of part-time study. This change is to apply to 2007 and later years.

Since Quebec's recent budget proposed an education savings incentive program similar to the CESG, the federal government is committed to making required changes to ensure the Quebec program is treated consistently with the CESG program.



### Registered Disability Savings Plan (RDSP)

This budget proposes a new program in 2008 to help parents and others save for the long-term financial security of a severely disabled child by introducing the RDSP (as recommended by the Expert Panel on Financial Security for Children with Severe Disabilities) with a Canada Disability Savings Grant (CDSG) and Canada Disability Savings Bond (CDSB) program. The RDSP generally will be based upon the existing RESP design. However, more technical details will be forthcoming when the implementing legislation is brought forward.

The following is a summary of the key elements:

- **Eligibility:** any Canadian resident eligible for the disability tax credit (the beneficiary of the RDSP and having a Social Insurance Number), or his/her parent or legal representative. Such requirements are to be met when established and whenever contributions are made.
- **Tax treatment:** contributions are non-deductible and are not included in income when paid out. Investment earnings accrue tax-deferred in the RDSP and are taxable to the beneficiary when paid out (along with the CDSGs and CDSBs).
- **Contributions:** limited to lifetime maximum of \$200,000 with respect to the beneficiary, and there's no annual limit. No restrictions on contributor and contributions are permitted until the end of the year in which the beneficiary reaches age 59.
- **CDSG:** for family net income up to \$74,357 – 300% on the first \$500 and 200% on the next \$1,000; for family net income over \$74,357 – 100% on the first \$1,000. Family net income amounts are to be indexed to inflation after 2007 when the RDSP becomes effective. CDSG lifetime limit is \$70,000 with respect to the beneficiary of an RDSP, and is available on contributions until the end of the year in which the beneficiary reaches age 49.
- **CDSB:** for lower income families – up to \$1,000 will be paid to RDSPs of low and modest income beneficiaries. The \$1,000 maximum is paid where family net income isn't greater than \$20,883, and is gradually phased out on family net income up to \$37,178. The lifetime CDSB limit is \$20,000 with respect to an RDSP beneficiary, and is available on contributions until the end of the year in which the beneficiary reaches age 49.
- **Payments:** required to commence by the end of the year in which the beneficiary reaches age 60 and are subject to maximum annual limits calculated by reference to the beneficiary's life expectancy, and the fair market value of the property in the RDSP. Encroachment is possible on income and capital in the RDSP. However, only the beneficiary or his/her legal representative may receive payments from the RDSP. Contributors are not permitted to receive any refund of contributions.
- **Clawback of CDSG and CDSB:** those amounts paid to the RDSP in the 10 years preceding a payment from the RDSP when the beneficiary ceases to be eligible for the disability tax credit, or his/her death.
- **Beneficiary's death, or ceasing to be eligible for disability tax credit:** the funds in the RDSP are required

(excluding CDSG and CDSB clawbacks) to be paid to the beneficiary or passed to the beneficiary's estate, and is considered income to the beneficiary.

- **Other means testing:** RDSP not considered for calculating other income-tested benefits provided through the income tax system, nor to reduce OAS or EI benefits.

Since most provinces and territories provide income support (means tested) to those who are disabled, it remains to be seen whether RDSP assets or payments will disqualify that beneficiary from provincial and territorial income support.

### **Phased Retirement**

Canadian tax rules currently prohibit employees from accruing pension benefits under a defined benefit RPP if already receiving a pension from the plan, or from a plan with a related employer. This restricts an employer from offering phased retirement programs, which allows older employees to continue working while receiving a partial pension and accruing benefits. These rules also restrict an employer from paying a partial pension, and older workers from increasing their pension benefits through full-time work.

The budget proposes tax rule amendments to give employers and employees this flexibility; that is, to permit an employee to receive pension benefits from a defined benefit RPP and still accrue future benefits (subject to certain restrictions). We'll examine in a future bulletin these proposed technical rule changes to allow phased retirement benefits from an RPP.

### **Age Limit for Maturing RPPs and RRSPs**

Currently, tax rules require RPPs, RRSPs and DPSPs to mature by the end of the year in which the plan member or annuitant reaches age 69. For 2007 and later years, the budget proposes an increase in conversion age for such plans to age 71. This means individuals reaching age 70 or 71 in 2007 (who have contribution room) will be able to make RRSP contributions. As well, in 2008, those age 70 in 2007 will be able to contribute. Minimum amount withdrawals also will be waived in 2007 and 2008 (as applicable) for such individuals. Those 71 or younger at December 31, 2007, will be able to reconvert a RRIF to an RRSP, provided the RRSP is then converted back to a RRIF before the end of the year in which this individual attains age 71.

Existing plans will be permitted to be amended without tax implications to reflect the later (age 71) conversion age. Likewise, employers with RPPs will be allowed to amend their RPPs to allow benefits to accrue, and

contributions to be made, for employed members who are age 71 or younger at the end of 2007.

### **RRSP and other Registered Plan Qualified Investments**

The budget proposes to expand the qualified investments of RRSPs and other registered plans to include:

- any debt obligation that has an investment grade rating and is part of a minimum \$25 million issuance, and
- any security (other than a futures contract) listed on a designated stock exchange.

This change is intended to offer registered plan investors greater investment choice and diversification, effective March 19, 2007.

### **Working Income Tax Benefit**

This budget proposes to address the plight of many low-income Canadians who may have no incentive to take a job, since taking on a low-paying job can mean losing a large portion of each dollar to income tax, or receiving reduced income support. This budget introduces the Working Income Tax Benefit (WITB) in 2007 as a refundable tax credit equal to 20% of each dollar of income in excess of \$3,000, to a maximum credit of \$500 for single individuals without dependants, and \$1,000 for families (couples and single parents).

To ensure the assistance reaches low-income earners, the credit is reduced by 15% of net family income in excess of \$9,500 for single individuals, and \$14,500 for families. In this case, net family income will be calculated on the same basis as is used for the Canada Child Tax Benefit and the goods and services tax credit – which is total income less the Universal Child Care Benefit, and any allowable deductions, such as pension contributions and child care expenses.

The WITB is supplemented for persons with disabilities.

### **Donations and Private Foundations**

Since the first introduction in 1997 of the reduced capital gains inclusion rate, encouraging and allowing greater flexibility in donating publicly-traded securities has been an important budget theme.

The 2007 budget continues this trend by encouraging and enhancing donations to private foundations by eliminating capital gains taxation arising from the donation of publicly-traded securities. Likewise, similar treatment is to be given to the donation of securities acquired and donated by an arm's length employee within 30 days of exercising stock options.

This change is effective for gains and income arising from the donation of such securities on or after March 19, 2007.

Until this budget, private foundations have faced restrictive donation rules over a concern about self-dealing. While the above rules have been relaxed and now facilitate private foundation donations, the 2007 budget proposes additional rules to address excess business holdings with respect to both publicly-traded and unlisted securities. The proposed additional rules will incorporate the following:

- Excess business holding ranges (i.e. safe harbour, monitoring phase, divestment required)
- Anti-avoidance measures
- Public disclosure
- Non-arm's length persons
- Compliance periods
- Transitional provisions
- Limitation for foundations in transition
- Gifts made conditional upon foundation retaining securities
- Penalties, and
- Related measures.

### Business Measures

The following represent 2007 budget tax measures affecting Canadian businesses:

#### **Capital Cost Allowance (CCA) Rates Aligned to Useful Life of Assets**

The 2007 budget proposes the following capital cost allowance (CCA for tax purposes – depreciation for accounting purposes) tax relieving measures for certain asset classes acquired by a business on or after March 19, 2007:

- CCA on buildings used in manufacturing or processing increases to 10% from 4%
- CCA on other non-residential buildings increases to 6% from 4%
- CCA on computer equipment increases to 55% from 45%, and
- CCA (on a straight-line basis only) on manufacturing and processing machinery and equipment increases to 50% from 30% (but only as a temporary relieving measure for machinery, and only equipment acquired prior to 2009 is eligible).

In keeping with the budget's environmental theme, certain other assets acquired on or after March 19 will be eligible

for accelerated CCA (i.e. those rates generally available for "clean energy generation" assets will be extended to wave and tidal energy, solar heating, stationary fuel cells, production of biogas from organic waste, and pulp and paper waste fuels).

#### **Incentive for Provinces to Eliminate Capital Taxes**

While many provinces are in the process of eliminating their capital taxes, the 2007 budget offers an additional interim financial incentive for them. However, for a province to be eligible for the federal incentive payment, the province must eliminate or restructure its existing capital tax system on or before January 1, 2011.

#### **Increasing Corporate Income Tax Instalment Threshold to \$3,000, and Reducing Instalment Frequency for Small Business Tax Instalments and other remittances**

Similar to the relief in this budget for individuals who make instalment tax payments, the threshold amount (above which corporations are also required to pay corporate income tax instalments) is to be increased to \$3,000 for tax years beginning in 2008.

Relief is also available for small Canadian-controlled private corporations (CCPCs) making monthly tax instalments. The budget proposes to permit these CCPCs to make their tax instalments on a quarterly basis. In this same vein, there are proposed changes in the budget for corporations making the required remittances of payroll deductions and goods and services tax/harmonized sales tax (GST/HST).

#### **International Taxation**

**Canada-U.S. Tax Treaty changes:** The budget proposes eliminating withholding tax on interest paid between Canada and the U.S. in the first calendar year following the entry into force of changes to the Canada-U.S. tax treaty for persons dealing at arm's length. On the other hand, for persons dealing at non-arm's length, the maximum withholding rate on interest payments will be reduced (on a three year phase-in basis) as follows:

- to 7% for the first year,
- to 4% for the second year, and
- to 0% for the third and subsequent years

after the entry into force of the treaty changes.

The budget also proposes that withholding tax ultimately be eliminated on interest paid to all arm's-length non-residents (without regard to their country of residence), once the above exemption is fully implemented (for both arm's-length and non-arm's-length persons) under the

changes to the Canada-U.S. treaty.

**International tax fairness initiative:** the 2007 budget proposes to restrict the deductibility of interest on debt incurred by corporations to finance foreign affiliates. Under this change, interest expense otherwise incurred will be pooled for deduction (net of exempt surplus received) if the foreign affiliate's shares generate non-exempt income for the corporation. This new restriction will apply as follows:

- to interest payable after 2007 on new debt incurred on or after March 19, 2007,
- after 2008 for existing non-arm's-length debt, and
- after 2009 for existing arm's-length debt.

The budget also proposes to better define the active business of a foreign affiliate since, under current rules, certain foreign affiliate passive income can be recharacterized as active business income. Since the government doesn't view this as appropriate (i.e. where the Canadian taxpayer has little or no equity interest in the foreign affiliate), a Canadian taxpayer now will be required to hold a qualifying interest (i.e. at least a 10% direct or indirect economic interest) in a paying (foreign) entity to have these payments treated as active business income. This change is to apply to foreign affiliates for their years that begin after 2008.

Finally, the international fairness initiative includes:

- enhancements to Canada's ability to collect tax information from other jurisdictions with the help of revised tax treaties (i.e. require all new tax treaties and revisions to existing treaties to include the new Organization for Economic Co-operation and Development (OECD) standards in relation to exchange of tax information, and Tax Information Exchange Agreements (TIEAs)
- amend the exemption for foreign source active business income (currently limited to income earned in countries with which Canada has a tax treaty) to include countries that have signed TIEAs, and
- provide additional funding for CRA audit and enforcement in this area.

### **Investment Tax Credit for Child Care Spaces**

The budget proposes a new investment tax credit (ITC) for businesses that create eligible child care spaces for children of their employees. The ITC is calculated as 25% of eligible expenditures (incurred after March 19, 2007) to a maximum credit of \$10,000 per child care space created. Eligible expenditures include depreciable property (i.e. building additions, equipment, furnishings, playground equipment, etc., but excluding automobiles

and property located in or attached to a residence of the employer, or of a person that holds an interest in the employer) and certain start-up costs (i.e. landscaping, architect fees, regulatory inspections, licence fees, building permits, and educational material).

Additional incentives provide for a three-year carry back of unused credits and a 20-year carry forward. However, it should be noted there's also a recovery of the ITC if, within the following five years (after creating the child care space), it ceases to be available, or property that was an eligible expenditure is sold, leased or converted to another use.

### **Other Measures**

#### **Trust T3 Information Slips**

The federal government is aware of concerns expressed by taxpayers and their tax preparers about the current due date for the issuance of Trust T3 information slips.

The government will continue to work with the investment fund industry to develop a process that will balance taxpayer wishes (tax filing) with those of commercial trusts (time needed to compute income and prepare tax returns and information reporting slips). The government expects to soon introduce draft regulations to provide for a more efficient process for 2007 T3 information slips.

#### **Previous Announcements**

The 2007 budget confirms the government's earlier announcements, including the following:

- October 31, 2006, Tax Fairness Plan, and
- December 19, 2006, Child Fitness Tax Credit.

While the Tax Fairness Plan included provisions for pension income splitting, the 2007 budget contains no further details or information about this subject.

#### **Other Tax Measures**

The 2007 budget proposes to extend the 15% mineral exploration tax credit by another year to March 31, 2008, and double the value of goods that may be imported duty and tax free to \$400 from \$200 by returning Canadian residents after a 48 hour absence. The 24-hour and seven day duty-free exemptions remain at \$50 and \$750, respectively. There are no changes to the volume and quantity restrictions on alcohol and tobacco products.

A new "Green Levy" is proposed on certain new automobiles (excluding pick-up trucks) that exceed a certain weighted average fuel consumption. This new levy will apply to new vehicles delivered (to dealers), or to new vehicles imported after March 19, 2007. This

means existing inventory isn't subject to the levy, nor sales confirmed in writing before March 20, 2007, provided the consumer takes possession of the vehicle before July 2007.

## The Bottom Line

The 2007 Federal Budget was designed to recognize Canada's strength today, and plan for its future. While this bulletin has focused on the budget's tax changes, there are many areas of spending in this budget, including health care and the environment, that will be of equal interest and importance to many Canadians. There are obvious previously announced tax changes for which we expected to have the details in this budget, but for which we must now patiently wait for more information to come at some future point.

It remains to be seen how the budget's success or failure plays out in light of the Conservative government's minority position.

If you have any questions regarding the contents of the 2007 Federal Budget, simply contact the **AIC Tax and Estate Planning Group** at 1-866-TAX-SMRT (829-7678), or by e-mail at [taxsmart@aic.com](mailto:taxsmart@aic.com).

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