

# Tax Alert

## Federal budget 2009: Stimulus spending, modest tax relief

Under extraordinary political pressures and challenging economic times, the minority Conservative government delivered its 2009 budget. Unlike past budgets, and following the lead of many other countries, this year's budget is primarily aimed at addressing Canada's slumping economy through a series of fiscal initiatives.

In line with the IMF's recommendation that governments introduce stimulative packages of approximately 2% of GDP, Canada's fiscal 2009 measures amount to 1.9% of GDP. This is lower than the proposed US package, which is estimated to be approximately 3%, but higher than other developed countries such as Germany, Japan and France.

Through a variety of expenditure and tax measures, the budget addresses broader economic concerns such as job creation, productivity initiatives and wage preservation, restoring confidence in the financial markets, enhancing Canada's competitiveness in attracting and maintaining human and non-human capital, and growth in the GDP. To this end, the government has decided to part from a string of successive surpluses towards a projected annual deficit of approximately \$34 billion for the 2010 fiscal year.

The primary thrust for the budget's stimulative initiatives stems from the sharp economic slowdown of the global economy, including the US — Canada's primary trading partner. The global recession has affected Canada's economy through weaker demand for Canadian export products, including natural resource commodities, manufactured goods, and services.

The minister has revised the projection of real and nominal GDP downward. Real GDP is expected to decline by 0.8% in fiscal 2009, as compared to the initial forecast of a 0.3% growth rate. Nominal GDP, initially estimated to increase by 0.8%, is expected to decline by 1.2%. These revised forecasts will likely lead to an increase in the country's unemployment rate and challenges to tax revenue collection.

One of the budget's primary initiatives aims to address the impact of the global financial crisis and liquidity contractions on Canadian businesses. The budget introduces measures aimed at providing greater access to financial capital for individuals and businesses, ensuring operational continuity.

With the anticipation of a recession for the Canadian market, the budget introduces measures to address stability in the labour market through job-creation initiatives. Initiatives include investments in provincial, territorial, and municipal infrastructure, First Nations infrastructure, knowledge infrastructure, and through a variety of federal government infrastructure projects.

The budget addresses competitiveness, including a variety of measures aimed at incentivising firms and individuals to invest in training. Other incentives include tax and tariff relief measures for firms investing in capital assets. Incentives to enhance the use of capital in production can lead to an increased level of labour productivity.

The budget also introduces measures to help retain skilled labour, including an increase in the basic personal amount and the top of the two lowest income tax brackets by 7.5%. Although these measures will provide a benefit to labour, they will not likely be of significant benefit to highly skilled labour whose income is subject to the higher tax brackets.

The budget includes short-term incentives targeting certain industries, such as forestry, farming, tourism, media and entertainment, and small businesses. The challenge to a targeted incentive program is that it creates sector differences in effective tax burdens and potential distortions in the flow of investment across industries.

This budget faces a variety of challenges. Should the slowdown of the Canadian economy be more severe than anticipated, it could lead to higher unemployment, lower tax revenues, and a higher-than-planned deficit. The other challenge stems from the tight financial markets and the need for the government to raise funds to finance expenditures. Although the government has introduced measures to help relax liquidity constraints there is a risk that they may crowd out private investment.

It is somewhat surprising that there are no new or enhanced incentives related to investment in research and development. In a highly integrated global economy, R&D is not only important for the competitiveness of Canadian firms, but it is also an important contributor to overall productivity and wage preservation.

## **Business income tax measures**

### **Corporate tax reductions**

While there were no new corporate rate reductions announced, the minister confirmed Canada's direction to become the lowest corporate taxing jurisdiction among the major industrialized economies. He also restated the government's intention to collaborate with the provinces and territories to reach a 25% combined corporate tax rate.

The enacted Canadian federal general corporate income tax rates are summarized in Table A.

<b>Table A - Federal corporate income tax rates</b>					
	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
General corporate rate	19.5%	19.0%	18.0%	16.5%	15.0%
Small business rate	11.0%	11.0%	11.0%	11.0%	11.0%

### **Small business deduction**

The minister announced an increase from \$400,000 to \$500,000 in the annual business income limit of a Canadian-controlled private corporation (CCPC) eligible for the reduced small business tax rate. This increase is effective 1 January 2009 and is pro-rated for corporations with taxation years straddling this date.

Consequential to this change, the \$3 million expenditure limit for the enhanced investment tax credit rate for scientific research and experimental development (SR&ED) expenditures incurred by a CCPC will be reduced when taxable income in the previous year exceeds \$500,000 (currently \$400,000), and will be fully eliminated when taxable income exceeds \$800,000 (currently \$700,000). This change is effective for previous taxation years ending after 2008.

### **Accelerated capital cost allowance**

Continuing with the theme of prior budgets, the minister announced changes to capital cost allowance (CCA) rates.

#### **Temporary incentive for manufacturing and processing equipment**

The temporary increase in the CCA rate for manufacturing and processing equipment to a 50% straight-line rate has been extended for eligible assets acquired in 2010 and 2011. The half-year rule will apply, such that a full write-off may be claimed over three taxation years.

#### **Accelerated CCA for computer equipment**

The minister announced a temporary acceleration in the CCA rate for computer equipment (including systems software). Under existing proposed legislation, computer equipment acquired after 18 March 2007 qualifies for a 55% declining-balance CCA rate. This rate will be increased to 100% with no half-year rule such that a full write off may be claimed in one full taxation year. This change applies to eligible computer equipment acquired after 27 January 2009 and before February 2011.

### **Acquisition of control**

An acquisition of control is deemed to occur at the commencement of the day on which a corporation is actually acquired, unless the corporation makes an election for this provision not to apply. In this circumstance, control will be considered to have been acquired at the specific time during the day in which it was acquired. If this election is not made, in certain circumstances the taxpayer may not be eligible for the \$750,000 lifetime capital gains exemption available in respect of a disposition of shares of a small business corporation (SBC).

This budget proposes to eliminate this unintended result by providing that the status of a corporation as a CCPC, and hence as an SBC, will not change until the actual time of the acquisition. This proposal is in response to the 2006 Federal Court of Appeal decision in *La Survivance*.

## **Mandatory electronic filing**

Subject to certain exceptions, corporations with annual gross revenues in excess of \$1 million will be required to file their income tax returns electronically. This measure applies for taxation years ending after 2009.

In addition, electronic filing of information returns will be required for taxpayers filing more than 50 slips related to a particular return (such as T4s and T5s). This measure will apply for information returns required to be filed after 2009.

## **Penalties**

To ensure compliance with the mandatory electronic filing requirement, a new penalty will be introduced for filing corporate tax returns in an incorrect format. The penalty will be phased in for returns required to be filed after 2010.

The minister also announced a reduction in the penalties for the late filing of information returns and the filing of information returns in an incorrect format. The reduced penalties will apply for information returns required to be filed after 2009.

## **International measures**

In December 2008, the Advisory Panel on Canada's System of International Taxation released its report. The panel's mandate was to recommend ways to improve the competitiveness, efficiency and fairness of Canada's system of international taxation. The government is currently studying the recommendations in the report and will "provide a response in due course."

Other than section 18.2, discussed below, none of the recommendations were considered in the 2009 budget.

## **Interest deductibility**

Arguably, the budget's most significant proposal is to repeal section 18.2 of the Income Tax Act, which was introduced as part of the 2007 Anti-Tax Haven Initiative and scheduled to come into force in 2012. The section restricts the deductibility of interest in certain situations when a Canadian corporation borrows funds to finance a foreign affiliate, and a second deduction is available in a foreign jurisdiction (a so-called "double dip").

The stated rationale for the proposed repeal is the panel's conclusion on the negative impact of the provision on foreign investment by Canadian companies and the current global financial environment. In our view, the provision was misguided, and the repeal is the right course of action. The tax community and economists have been consistent in their criticism of the provision despite the minister's original determination in getting it passed, even though his reasons seemed to be more political than economic.

## **Non-resident trusts and foreign investment entities**

These much-maligned outstanding proposals were first introduced in the 1999 budget. The government continues to receive submissions on the rules, and the panel recommended a further review of the proposals to coordinate with potential changes to the foreign affiliate regime. The 2009 budget confirms the government will review the submissions, including those of the panel, prior to proceeding with measures in this area.

## Foreign affiliate proposals

The government confirmed it will consider the panel's recommendations prior to proceeding with the 2004 foreign affiliate measures. No timeline is indicated for this.

## Tax relief for individuals and families

### Personal tax: income thresholds

**Personal amounts** – The budget proposes to increase the basic personal amount and the amount for a spouse, common-law partner or wholly dependent relative from \$9,600 in 2008 to \$10,320 in 2009.

**Higher-income thresholds** – The budget aims to deliver on the government's Tax Back Guarantee to provide broad-based personal tax relief:

- ▶ The upper limit of the first personal income tax bracket (15%) will increase to \$40,726 in 2009 from \$37,855 in 2008
- ▶ The upper limit of the second personal income tax bracket (22%) will increase to \$81,452 in 2009 from \$75,769 in 2008

As a result of these changes, a single Canadian earning \$80,000 will pay \$259 less tax for 2009.

### Tax credits

The budget includes proposals for a number of new and enhanced tax credits, computed using the lowest personal tax rate (15%):

- ▶ **Home renovation tax credit** – For 2009, a new, non-refundable temporary tax credit will be available to homeowners for home improvements to a principal residence. The credit will apply to expenditures in excess of \$1,000 and up to \$10,000, made for work performed or goods acquired after 27 January 2009 and before February 2010, in relation to an agreement entered into after 27 January 2009. Eligible expenditures must be for renovations or alterations of an enduring nature. Routine repairs, appliances, furniture and fixtures are ineligible for the credit. Family members (spouses/partners and minor children) will share the expenditure limit.
- ▶ **First-time home buyers' tax credit** – Effective 2009, a new, non-refundable tax credit based on an amount of \$5,000 will be available for first-time homebuyers who acquire a qualifying home after 27 January, 2009. This will generate a one-time \$750 tax saving.
- ▶ **Age credit** – Effective 2009, the amount that is the basis for the age credit is increased by \$1,000, to \$6,408. This income-tested credit begins to be phased out at \$32,312 of net income and will be completely eroded at \$75,032 of net income.
- ▶ **Mineral exploration credit** – The mineral exploration tax credit, equal to 15% of specified mineral exploration expenses incurred in Canada and renounced to flow-through share investors, will be extended to flow-through share agreements entered into on or before 31 March 2010. This program, initially introduced in 2000, was previously extended and scheduled to expire on 31 March 2009.

### Registered plans

The dollar limit for withdrawals from RRSPs under the Home Buyers' Plan is increased to \$25,000 from \$20,000 effective for withdrawals made after 27 January 2009.

The budget proposes to permit the amount of post-death decrease in value of RRSPs or RRIFs to the time of distribution, to be carried back and deducted against the year-of-death RRSP/RRIF income inclusion. This measure is effective for final distributions occurring after 2008.

## Sales and excise taxes

### Simplification of GST/HST for direct sellers

Certain direct sellers who sell through a network of self-employed sales representatives will be permitted to register for a special GST/HST accounting method. This involves making a joint election with all of their representatives in order not to subject commissions or bonuses paid or sales aids to GST/HST, as long as none of the representatives is expected to earn more than \$30,000 in the fiscal year. This measure will be available for fiscal years of a network seller that begin after 2009.

### Tariff relief on machinery and equipment

The budget proposes to permanently eliminate tariffs on a range of machinery and equipment imported into Canada and used by Canadian industry, and to simplify the existing customs tariff structure.

## Other legislation

As a result of the prorogation of Parliament on 4 December 2008, all outstanding legislative proposals “died on the Order Paper” and will have to be reintroduced. The government confirmed its intention to reintroduce a number of previously announced corporate measures:

### Notice of ways and means motion, 28 November, 2008

The minister released draft legislation to implement the remaining tax measures from the 2008 budget, along with several previously announced initiatives.

The significant measures include:

- ▶ **International tax measures** relating to the computation of income, gains and losses of a foreign affiliate.
- ▶ **Amendments to the taxation of financial institutions** relating to mark-to-market properties.
- ▶ **Conversion of specified investment flow-through (SIFT) entities** into corporations without any undue income tax consequences.
- ▶ **Extension of carryforward period for unused ITCs** earned by Canadian businesses in taxation years 1998 to 2005 from 10 years to 20 years.
- ▶ **Extension of the acquisition-of-control provisions** to a corporation’s accrued capital gains and losses from foreign currency fluctuations on debt liabilities denominated in a foreign currency.

### Functional currency reporting

Draft legislation released on 10 November 2008 includes the proposed amendments announced on 27 June 2008, the extension announced on 29 October 2008 to make the functional currency election, and a number of new rules for technical, interpretative and practical issues that emerged from the current provisions.

## Bill C-10

During the recent federal election, the Department of Finance announced that it would not reintroduce the proposed controversial changes to the film and video tax credit eligibility. There was no indication as to when the rest of the numerous measures contained in the bill will be reintroduced.

Bill C-10 includes the proposed foreign investment entity and non-resident trust rules, restrictive covenants rules, rules preventing stock option benefits from being SR&ED expenditures, and a number of technical amendments, some of which are retroactive to 1999.

## Webcast

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