RBC Dominion Securities

THE ADVISOR

February 26, 2008

The 2008 Federal Budget – February 26, 2008

A Summary of the Key Tax Measures Contained in the Budget and How These Changes Impact You

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Financial Advisory Support

Federal Finance Minister Jim Flaherty delivered the Conservative government's third budget on February 26, 2008. Key highlights include: a new Tax Free Savings Account; an increase in the life span of RESPs; and a reduction in the dividend gross-up factor and the federal dividend tax credit for eligible dividends.

***Please note**: There is an element of risk in proceeding with a tax planning strategy that is based on any proposals contained in the budget that have not yet been enacted into law. Historically, the process through which budget proposals become law is a multi step process that may take a few months to a few years to complete. It is also possible that a budget proposal will never become law.*

While it has been the longstanding practice of Canada Revenue Agency (CRA) to allow taxpayers to file their tax returns based on proposed legislation, a taxpayer remains potentially liable for taxes under the current law in the event that the budget proposal is not ultimately passed. Therefore, if proposed legislation is not passed, it is possible that CRA may assess or re-assess your tax return based on existing legislation. It is recommended that you consult a professional tax advisor to assist you in assessing the costs and benefits of proceeding with specific budget proposals as they relate to you.

Personal Income Tax Related Measures

Tax-Free Savings Account

The federal budget proposes to introduce, possibly as early as 2009, the Tax-Free Savings Account (TFSA). This account appears to have elements of both a non-registered account and an RSP.

It is similar to an RSP in that funds within the account grow tax-free, the account is subject to the same qualified investment rules and subject to a similar concept of "contribution room". Unlike an RSP, your TFSA contributions are not deductible and your withdrawals are never subject to income tax. This means your investment will be made with after-tax dollars, similar to an investment into a regular non-registered account, however the income on the investments will be tax-free. Since your withdrawals will not be subject to tax and will not be considered as taxable income, it would not impact your income-tested benefits and income tax credits such as Old Age Security, Employment Insurance benefits and your entitlement to the age credit.

<u>Contribution Room</u>

All Canadian residents, age 18 and older will acquire $5,000 of contribution room each year, indexed to inflation, regardless of income. Similar to your RSP contribution room, the Canada Revenue Agency (CRA) will determine and track your TFSA contribution room as you file your tax return each year. Unused contribution room will be carried forward indefinitely. Amounts withdrawn from the plan, including the tax-free growth, will be added back to your contribution room for the following year which means you will be able to withdraw amounts and reinvest those same amounts as you choose without loosing any contribution room. This type of "revolving" contribution room will help you meet your financial planning goals throughout your lifetime since you will be able to save funds in this account and withdraw funds as necessary without loosing your ability to reinvest in this account for future goals.

Income Splitting Opportunity

The budget proposes that since the income earned within the TFSA is not taxable, contributions made by a taxpayer into their spouse's TFSA would not be subject to the income attribution rules.

Unlike conventional income splitting strategies that consider the source of the invested funds, this account allows for you and your spouse to both earn tax-free investment income regardless of whose money is invested. Also, relative to traditional income splitting strategies, your TFSA will also allow for greater tax savings, thus greater investment growth and in a shorter time frame.

Financial Planning Opportunities

The various attributes of the TFSA including the tax-free investment income, the ability to invest in your spouse's plan without triggering attribution, the revolving contribution room and the fact that the withdraws do not effect any income tested benefits or clawbacks can provide you with greater flexibility for savings and investments throughout your lifetime. Though the TFSA may add to the overall complexity of your financial situation, it will also provide you with more flexibility with regards to choosing which sources of income to draw upon during retirement.

The TFSA is an ideal compliment to an RSP, especially if you are able to make the maximum contribution to each of these two plans each year.

Since the investment income earned within the TFSA is not taxable, any interest paid on funds borrowed to invest in the TFSA will not be deductible for income tax purposes. Unlike RSPs, there will not be any constraints with respect to using your assets within your TFSA as collateral for a loan.

Increased Flexibility for RESPs and EAPs

The budget proposes to increase the life span of RESPs in three ways. First, contributions can now be made into the plan for 31 years, up from the previous 21 years, for individual and family plans. Second, the deadline for the plan termination has been extended from the 25th anniversary of the plan to the 35th anniversary of the plan. And third, the maximum age for the beneficiaries of a family plan for which contributions can be made has increased from 21 years of age to 31 years of age. Also, for beneficiaries of individual plans that qualify for the disability tax credit (DTC), contributions can now be made until the age of 35 and the plan must be terminated by the 40th anniversary of the plan. These changes are proposed to be effective for 2008 and subsequent taxation years.

The increased time limits provide flexibility for families wishing to help finance education for older children, those entering graduate school, those starting post-secondary education at a later age or where there is a greater age gap between beneficiaries in family plans. There is a one potential issue to be aware of that results from the increased time frame. Greater growth over the lifetime of the plan may result in a greater amount of excess funds in the plan at termination and the possibility of larger adverse tax consequences if the funds cannot all be used to finance educational needs.

Proposed changes to Educational Assistance Payments (EAPs) would provide a grace period to allow beneficiaries to receive EAPs for up to six months after they have ceased to be enrolled in a qualifying post-secondary program. Payments must qualify under the rules for EAPs but could give students more flexible access to funds to pay late-occurring expenses and accommodate a wider range of personal circumstances. This measure will apply to RESP beneficiaries who cease to be enrolled in a qualifying education program after 2007.

Dividend Tax Credit

The budget proposes to reduce the dividend gross-up factor and the federal dividend tax credit for eligible dividends (generally dividends received from Canadian public corporations). This is in response to the reduction in the corporate tax rates that were announced in the October 30, 2007 Economic Statement. The dividend gross-up factor will be reduced from its current level of 45% to 44% effective January 1, 2010, 41% effective January 1, 2011 and 38% effective January 1, 2012. The federal enhanced dividend tax credit rate will correspondingly be reduced from its current level of 19% to 18% effective January 1, 2010, 16.5% effective January 1, 2011, and 15% effective January 1, 2012.

These changes will result in an increase in the effective federal tax rate on eligible dividends from 14.55% to 19.29% by 2012, assuming no further tax rate changes. Consequently, in 2012 the federal tax rate on eligible dividends will almost be equal to the federal tax rate on non-eligible dividends. The federal tax rate on non-eligible dividends is currently 19.59% (The rates are summarized in the table below). These changes will affect owner-manager tax planning such as bonusing down to the small business limit or whether it is better to receive dividends vs. salaries. The analysis will be different for each province.

	Eligible Dividends						**Non-Eligible Dividends**
	2008	2009	2010	2011	2012		2008 - 2012
Gross-up	45%	45%	44%	41%	38%		25%
Enhanced DTC	19%	19%	18%	16.5	15%		13.33%
Total federal tax	14.55%	14.55%	15.88%	17.72%	19.29%		19.59%

Changes to Registered Disability Savings Plans (RDSP)

The RDSP was originally introduced in the 2007 budget. However, the 2008 budget explains that the government has not completed the regulations containing the details necessary to implement the Canada Disability Savings Grants (CDSGs) and Canada Disability Savings Bonds (CDSBs). Until the regulations are finalized, financial institutions will be delayed in building the infrastructure required to enable them to offer the RDSP. In addition, the budget provides more clarity as to the sustainability of the plan in the event that the beneficiary rescinds his or her disability tax credit certification.

Capital Gains and Donations: Exchangeable Shares

The budget proposes to eliminate the capital gain triggered on the conversion of certain unlisted exchangeable shares or partnership interests into publicly traded securities if the converted publicly traded securities are gifted to a registered charity within 30 days of exchange. In addition, at the time the unlisted security is issued, it must be exchangeable into the publicly traded security and the publicly traded security must be the only consideration received on exchange.

The donation of exchangeable securities that are partnership interest may trigger a capital gain where the adjusted cost base (ACB) of the partnership interest has been reduced by operating losses. Based on discussions with the Department of Finance, these rules will not apply to flow through shares where renounced deductions are claimed and used to reduce the ACB.

These proposals apply to donations made on or after February 26, 2008.

If you received any exchangeable shares from some of the recent corporate reorganizations and have philanthropic intentions, this proposal could help you fulfil your goals to provide for others and save tax on your gift.

Medical Expense Tax Credit

For the 2008 and subsequent taxation years, the budget proposes additions to the list of devices, prescribed by a medical practitioner, that would qualify for the medical expense tax credit. In addition, the cost, including the cost of related care and maintenance, of service animals specially trained to assist individuals who are severely afflicted by autism or epilepsy will qualify for the credit. If you have a medical condition, you should review this tax credit annually.

Corporate Income Tax Related Measures

Update on Taxation of Publicly Traded Income Trusts/Partnerships

On October 31, 2006 changes impacting certain distributions made by publicly traded income funds, income trusts or partnerships were introduced under the specified investment flow-through (SIFT) entity tax rules. These rules applied a federal general corporate tax and an additional tax in lieu of provincial tax at a flat rate of 13% (average of provincial rates) on distributions made by publicly traded income trust/partnership. For a publicly traded income trust/partnership that existed on or before October 31, 2006, these above rules apply starting in 2011.

The 2008 budget proposes to replace the flat provincial rate of 13% with the provincial general corporate income tax rate for each province in which the publicly traded income trust/partnership operates its business. The provincial general corporate income tax rate ranges from 10% to 16%. For publicly traded income trusts/partnerships established after October 31, 2006, the proposed rules would apply starting in 2009. For publicly traded income trusts/partnerships that existed on or before October 31, 2006, the proposed provincial rate will apply starting in 2011.

Another important policy intention confirmed by the government in this budget is their desire to allow publicly traded income trusts/partnerships to convert to corporate form generally on a tax deferred basis.

Other Proposed Measures

Northern Resident Deduction - Beginning in 2008, the basic residency deduction for individuals who live in prescribed areas in northern Canada will be increased by 10% from $7.50/day to $8.25/day.

Mineral Exploration Tax Credit - The eligibility for the mineral exploration tax credit of 15% will be extended to flow-through share agreements entered into on or before March 31, 2009.

Private Foundations: Excess Corporate Holdings – The budget proposes to relieve private foundations from the obligation to dispose of certain holdings of unlisted shares.