



Ontario Budget – March 22, 2007

BUDGET OVERVIEW

On March 22, 2007, Ontario Finance Minister Greg Sorbara delivered the 2007 Ontario budget (the “Budget”). The Budget, which contains no personal or corporate income tax rate changes, projects a budgetary surplus of \$310 million for the 2006-07 fiscal year. The Finance Minister also anticipates surpluses in each of the subsequent three fiscal years.

The Budget focuses on addressing child poverty, through numerous measures, the most important of which is the introduction of the Ontario Child Benefit program which will provide \$2.1 billion of support to low income families over five years. The hourly minimum wage will increase to \$10.25 (from \$8.00) by 2010, with three annual increases of 75 cents starting on March 31, 2008. Improvements to the fairness of the property tax system are also proposed.

The Budget proposes the following significant tax changes:

- To accelerate the elimination of the capital tax by 2010.
- To introduce adjustments to the Ontario Scientific Research & Experimental Development (“SR&ED”) regime to harmonize the Ontario SR&ED incentives with the federal regime. These measures complement recently announced proposed changes designed to bring other Ontario tax attributes (such as loss carryovers and undepreciated capital cost allowance pools) in line with federal attributes. These changes are in conjunction with the implementation of the agreement with the federal government for a single corporate tax administration, effective for taxation years ending after December 31, 2008.
- To outline details of the new proposed 4.5% non-refundable tax credit in respect of Ontario qualifying SR&ED expenditures, effective for taxation years ending after December 31, 2008.
- To extend the Apprenticeship Training Tax Credit (“ATTC”) to include salaries and wages paid prior to January 1, 2015 to eligible apprentices, who commence employment before January 1, 2012. In addition, the list of skilled trades that will qualify for the ATTC will be expanded.
- To extend the Ontario Production Services Tax Credit to March 31, 2008.

- To extend the carryforward period for corporate minimum tax (“CMT”) credits and losses to 20 years (currently 10 years), for credits and losses arising in taxation years ending after March 22, 2007.
- To amend the CMT rules to eliminate the impact of certain recent accounting changes.
- To parallel recent federal budget proposals to allow senior couples to split certain types of pension income, effective for 2007.
- To extend the Retail Sales Tax exemption for destination marketing fees billed on accommodations until June 30, 2008.
- To improve the fairness of the property tax system by reducing the business education tax, by introducing a four-year current value assessment cycle with a mandatory phase-in of increases, and by eliminating the Greater Toronto Area pooling system.

The highlights of the tax changes announced in the Budget are summarized below. In addition, our commentary discusses the recent proposed transitional rules regarding the integration of the Ontario and federal tax systems.

BUSINESS TAX MEASURES

Elimination of Capital Tax by 2010

Capital tax is currently slated to be completely phased-out by January 1, 2012. The Budget proposes to accelerate the elimination date to July 1, 2010 for all corporations.

The following schedule sets out the current and the proposed timetable for the phase-out process, for corporations other than financial institutions:

Effective date	Capital Deduction	Capital Tax Rate (%)
January 1, 2006	\$10 Million	0.3
January 1, 2007	\$12.5 Million	0.285
January 1, 2008	\$15 Million	0.285
January 1, 2009	\$15 Million	0.225
January 1, 2010	\$15 Million	0.15
July 1, 2010	Eliminated	Eliminated

The rate changes and the proposed elimination will be pro-rated for taxation years straddling the effective dates.

Harmonization Measures for Scientific Research & Experimental Development (“SR&ED”)

Currently, in calculating Ontario taxable income, Ontario provides a deduction equal to the portion of the federal investment tax credit (“ITC”) that relates to qualifying SR&ED expenditures undertaken in Ontario. Once the federal government becomes responsible for the administration of Ontario’s corporate income tax, this incentive will automatically expire for taxation years ending after 2008. The 2006 Economic Outlook and Fiscal Review proposed to replace this deduction with a non-refundable tax credit equal to 4.5% of the “eligible SR&ED expenditures”, effective for taxation years ending after 2008.

The Budget outlines additional details of the proposed tax credit, including the definition of an eligible SR&ED expenditure, that the credit may be carried back for three years (other than to taxation years prior to 2009) and carried forward for twenty years, continuation rules to permit unused credits to be carried forward after an amalgamation or winding-up, and recapture and change of control rules similar to those that apply to the federal ITC.

The Budget also proposes that the amount of a corporation’s relevant federal ITCs earned in taxation years ending before 2009 will be added to the corporation’s total Ontario tax credit balance, to the extent that those ITCs have not expired for federal purposes, have not been taken into account in the calculation of the existing Ontario incentive, and were not earned prior to the last time that control of the corporation was acquired.

In addition to the foregoing, it is not uncommon for corporations to have different tax pool balances for federal and Ontario purposes, such as for example, unclaimed non-capital losses and SR&ED expenditures. Where these pool balances differ between federal and Ontario, the federal pools will prevail upon harmonization. This will require upward or downward adjustments to the Ontario pools, which may result in future Ontario tax gains or losses for corporations. These measures are described in more detail under the heading “OTHER RECENT PROPOSALS”.

In order to lessen any cash flow issues facing a corporation which may be subject to an Ontario tax liability arising as a result of the harmonization to the federal system, the Budget proposes to allow a corporation to defer its Ontario tax debits relating to its federal SR&ED pool balance by electing to reduce the federal SR&ED pool balance. Provided the corporation does not utilize the elected federal pool balance from 2009 – 2015 in excess of what it has incurred as SR&ED expenditures for those years, the Ontario tax debits relating to the federal SR&ED pool balance could be deferred for at least seven taxation years.

Apprenticeship Training Tax Credit (“ATTC”) Extended and Expanded

The Budget proposes to extend and expand the ATTC, which encourages the hiring of apprentices in certain skilled trades by providing corporations and unincorporated businesses with a 25% refundable tax credit (30% for certain small employers) on certain salaries and wages paid to certain apprentices.

The ATTC is available for eligible expenditures of up to \$5,000 per year per eligible apprentice in a qualifying skilled trade, to a maximum of \$15,000 over the first 36 months of the apprenticeship. The maximum annual tax credit of \$5,000 will be pro-rated for the number of days that the apprentice is employed with that employer during the year. The Budget proposes to extend the ATTC to eligible apprentices who commence employment before January 1, 2012 (currently January 1, 2008). Eligible expenditures will be comprised of salaries and wages paid prior to January 1, 2015 (currently January 1, 2011).

Qualifying skilled trades eligible for the ATTC will be expanded to include the following:

- Entertainment industry power technician
- Process operator – power
- Tractor-trailer commercial driver
- Exterior insulated finish systems mechanic
- Information technology call centre inside sales agent
- Information technology call centre customer care agent.

The above trades will be added to the current list of 117 designated construction, industrial, motive power and service trades that currently qualify for the ATTC.

Ontario Production Services Tax Credit (“OPSTC”) Extended

The OPSTC is an 18% refundable tax credit for Ontario labour expenditures incurred by certain foreign-based and domestic film and television productions. The Budget proposes to extend the OPSTC to labour expenditures incurred before April 1, 2008.

Ontario Computer Animation and Special Effects Tax Credit (“OCASE”)

The OCASE is a 20% refundable tax credit for eligible Ontario labour expenditures incurred by corporations in respect of digital animation and digital visual effects carried out in Ontario for use in film and television productions. In order to simplify the claims process, the Budget proposes to allow a wholly-owned subsidiary to claim the OCASE in respect of eligible labour expenditures incurred by its parent corporation, in respect of productions commenced by the subsidiary after March 22, 2007.

Corporate Minimum Tax (“CMT”)

The CMT ensures that corporations subject to Ontario tax do not unduly reduce their Ontario income tax liability through the use of tax preference items. The CMT is equal to the amount by which 4% of net income, determined in accordance with accounting principles, exceeds corporate income tax. In order that the CMT acts as a prepayment of corporate income tax, rather than as an additional income tax liability, a credit is provided for the amount of CMT paid, which can then be applied against the corporation's corporate income tax in excess of its CMT liability in a succeeding taxation year.

The Budget proposes a number of changes to the CMT legislation, as follows:

- The present carryforward period for CMT paid is 10 years. The Budget proposes that, for taxation years ending after March 22, 2007, the CMT credit carryforward period be extended to 20 years. Furthermore, for taxation years ending after 2008, it is further proposed that the carryforward period for CMT credits relating to taxation years ending before March 23, 2007, also be extended by 10 years to provide for a maximum 20-year carryforward period.
- Under present legislation, accounting gains derived from corporate reorganizations, as well as the replacement of assets where an income tax deferral is available, are excluded from the computation of CMT income, and will ultimately be recognized when the assets are disposed of in a transaction not involving a corporate reorganization. These rules can be complex, and require corporations to track their gains over many years. Consequently, the Budget proposes to simplify these rules, by eliminating the need to track and report the excluded accounting gains in the future when the assets are sold. This amendment will apply for dispositions, amalgamations or wind-ups completed after March 21, 2007.
- The Budget proposes to prevent the previous ability of a parent corporation, to both eventually deduct an accounting loss arising from the wind-up or amalgamation of a subsidiary with the corporation, as well as avail itself of the subsidiary's unused CMT losses, which get flowed through to the parent corporation upon the amalgamation or wind-up. The amendments would repeal the flow-through of the subsidiary's unused CMT losses, and would instead permit the parent corporation to deduct the full accounting loss. This amendment will apply for dispositions, amalgamations or wind-ups completed after March 21, 2007.
- The Budget proposes to amend the CMT legislation in order to clarify that income for CMT purposes is to be calculated without reference to unrealized gains or losses that are not required to be included in computing income for tax purposes. Similar adjustments will be made when calculating a corporation's total assets, for purposes of determining whether the corporation and any corporations associated therewith qualify for the exemption from CMT i.e. corporations whose total assets do not exceed \$5 million. These measures will be effective for taxation years ending after March 22, 2007.

PERSONAL TAX MEASURES

Pension Income Splitting

Commencing 2007, the Budget proposes to parallel the federal proposal to allow for senior couples to split certain types of pension income. This proposal will be subject to the federal proposal receiving Royal Assent.

Introduction of a More Flexible Life Income Fund (“LIF”)

The Budget proposes to introduce a new LIF, to replace all existing LIFs and locked-in retirement income funds (“LRIFs”). The new LIF will give seniors who hold retirement savings transferred from employment pension plans increased flexibility in managing their retirement income. The new LIF will eliminate mandatory annuity purchase requirements and will introduce, among other things:

- A right to a one-time unlocking of up to 25% of the locked-in funds, subject to certain restrictions.
- An amended annual payment schedule that will increase retirement income, and permit withdrawal of the entire remaining account balance when the LIF holder reaches age 90.
- The ability to withdraw additional income based on investment returns in prior years.

The government will begin a consultation process on the implementation of this proposed scheme, and anticipates implementing these proposals as early as January, 2008.

Increase in the Ontario Property and Sales Tax Credit (“OPSTC”) Income Threshold for Senior Couples

The Budget proposes to increase the OPSTC income threshold for senior couples, which is currently \$23,090 for 2006, in order to ensure that senior couples receiving the guaranteed minimum level of income from Old Age Security (“OAS”) and Guaranteed Income Supplement (“GIS”) will continue to benefit fully from the OPSTC. The new threshold amount will be announced when the federal government finalizes the OAS and GIS amounts for 2007.

Introduction of the Ontario Child Benefit (“OCB”)

The Budget proposes to introduce a new OCB program, which will provide monthly benefit payments to families with children under the age of 18, and will replace both the Ontario Child Care Supplement for Working Families and social assistance payments once the new OCB system is fully phased in. The OCB will be income-tested and will be delivered through the personal income tax system. The maximum annual OCB per child for 2007 will be \$250 and will increase to \$1,100 per child by 2011. The OCB will be phased out once the family’s net income exceeds \$20,000. The phase out rate will be 3.4% for 2007 and 8% thereafter.

Federal Universal Child Care Benefit

The Ontario government has enacted legislation to ensure that the new federal Universal Child Care Benefit does not affect eligibility for various income-tested provincial programs, such as OPSTC.

ONTARIO RETAIL SALES TAX (“RST”) MEASURES

RST Simplified Calculation for Software Businesses

RST applies to the provision of non-customized computer software and certain software services. Where a software supplier enters into a contract, which includes a combination of both taxable and non-taxable services, the supplier must determine the RST liability of the taxable components of the service contract.

In the 2005 Ontario Budget, the Ministry of Finance launched an RST pilot project for software businesses to simplify the calculation of RST. The pilot project allows the pilot-project registrants to use the optional simplified RST calculation method of 6% applied to the total contract price of the software services. The Budget proposes to extend the pilot period to March 31, 2009, in order to allow more time to evaluate its effectiveness.

RST Exemption for Destination Marketing Fees

The Budget proposes that the temporary RST exemption for destination marketing fees on accommodations be extended to fees billed on or before June 30, 2008. The eligibility rules will remain unchanged.

RST Rebate for Clean Home Energy Systems

To continue support for the production of cleaner energy, the Budget proposes that the temporary RST rebate for residential purchases of solar, wind, micro-hydroelectric and geothermal energy systems be extended to purchases made before January 1, 2010.

OTHER MEASURES

Tobacco Tax Enforcement

To further enhance Ontario’s efforts to enforce tobacco tax compliance and protect tobacco tax revenue, the Budget proposes a number of enforcement measures including the assignment of additional resources, increasing sanctions and enforcement measures, the suspension of a retailer’s ability to sell tobacco products, and authorizing the Canada Border Services Agency to collect the tax on tobacco brought into Ontario by post or courier.

Property Tax System

The Budget proposes a number of measures to enhance the fairness and predictability of the current property tax system, including:

- Reducing the Business Education Tax (“BET”) component of property taxes.
- Introducing a four-year current value assessment (“CVA”) cycle with mandatory phase-in of assessment increases.
- Improving the assessment appeal system.
- Eliminating the Greater Toronto Area (“GTA”) pooling system.

BET Rate Reductions

Currently, there is a wide variation in the BET component of property tax imposed on commercial and industrial properties, depending on the location of the business. Starting in 2008, the Budget proposes that the initial annual commercial ceiling rate be reduced to 2.5% for commercial properties and to 3.0% for industrial properties. For each year until 2014, further reductions will be made until the maximum BET rate is 1.6% for both commercial and industrial properties. Businesses subject to a BET rate in excess of 1.6%, but less than the annual ceiling rates, will benefit from phased-in BET rate reductions. In addition, all new construction initiated after March 22, 2007 will be immediately subject to the 1.6% BET ceiling rate.

Four-Year CVA Cycle

Under the current CVA system, property tax is based on the current market value of properties. When this system was introduced, it was intended that annual reassessments would be made to ensure equity between properties of similar value. However, the Government recognizes that the current system has led to concerns about volatile property tax changes for many homeowners.

The Budget proposes to move to a four-year cycle of reassessments. Under this system, property values will be reestablished on January 1, 2008 and will apply to 2009 to 2012 inclusive. The cycle will continue every four years.

Effective in 2009, the Budget proposes a mandatory four-year phase-in of property tax increases applicable to residential, farm and managed forest properties. The program would not apply to assessment decreases, which will be applied immediately. The Government intends to consult with municipalities and the Municipal Property Assessment Corporation (“MPAC”) to determine whether the program should be extended to other property classes, such as commercial, industrial and multi-residential.

Property Tax Appeal System

Currently, property owners who disagree with their assessment or tax classification have two options: (1) to make an informal “request for reconsideration” by MPAC, or (2) to file a formal appeal with the Assessment Review Board (“ARB”). Frequently the MPAC decision is not made prior to the deadline to file an appeal with ARB, leading to the filing of protective appeals with ARB pending the decision of MPAC. To improve the efficiency of the appeal process, the Budget proposes to convert to a process requiring a formal first stage assessment appeal, which may be further appealed to the ARB within a specified timeframe following the completion of the first stage appeal. In addition, the information disclosure requirements for the appeal process would be standardized.

Elimination of GTA Pooling System

The GTA pooling system redirects a portion of the taxes collected from certain contributing municipalities, such as York Region, Peel Region and Halton Region, to provide assistance primarily to the City of Toronto. The Budget proposes to phase out the GTA pooling over seven years, beginning in 2007. The Province will provide financial support through other programs to cover the social assistance and social housing costs currently funded under the system.

OTHER RECENT PROPOSALS

Single Administration and Harmonization of Ontario Corporate Income Tax

Effective for taxation years ending after 2008, the Ontario and federal government have signed an agreement that will transfer the administration of Ontario’s corporate income tax to the federal government, thereby reducing corporate income tax compliance costs for taxpayers and integrating federal and Ontario tax audits.

Under the single corporate income tax administration, Ontario will parallel the federal definition of taxable income. Therefore, the computation of federal taxable income will apply for Ontario tax purposes. Where tax deductions are based on balances in tax pools (such as undepreciated capital cost allowance balances and loss carryovers), it will be necessary to adjust the Ontario balances to bring them into alignment with federal tax pool balances.

On December 13, 2006, the Ontario government introduced draft legislation to address the integration of the Ontario and federal tax systems.

Under the proposed rules, commencing with taxation years ending after December 31, 2008, federal tax attributes will be adopted for Ontario tax purposes. The taxpayer’s federal tax attributes will be compared to the aggregate Ontario tax attributes, so that the taxpayer will have either an overall transitional gain (equal to the amount by which the aggregate federal tax attributes exceed the aggregate Ontario tax attributes) or an overall transitional loss (equal to the amount by which the aggregate Ontario tax attributes exceed the aggregate federal tax attributes).

The tax attributes to be changed to federal amounts, giving rise to an overall transitional gain or loss, include the following:

- Undepreciated capital cost
- Undeducted charitable contributions
- Cumulative eligible capital
- SR&ED pool
- Cumulative Canadian exploration expense, cumulative Canadian development expense and cumulative Canadian oil and gas property expense
- Non-capital loss and net capital loss carryforwards
- The sum of the adjusted cost bases for each partnership interest owned
- The sum of various income reserves, including a reserve under paragraph 20(1)(n) of the Income Tax Act in respect of the sale of income property
- 50% of capital gain reserves.

Ontario tax will be computed on the overall transitional gain or loss as follows:

$$\begin{array}{rcccl} \text{Overall transitional} & & \text{Ontario general corporate} & & \text{Percentage of income} \\ \text{gain or loss} & \times & \text{tax rate (now 14\%)} & \times & \text{allocable to Ontario} \end{array}$$

The Ontario tax applicable to an overall tax gain is referred to as a “transitional tax debit” and the Ontario tax applicable to an overall tax loss is referred to as a “transitional tax credit”. A taxpayer will generally be required to add its transitional tax debit, or deduct its transitional tax credit, from its Ontario income tax in five equal annual amounts commencing with taxation years ending after 2008. Transitional tax credits will not be refundable, but can be carried forward to subsequent years within the five-year transitional period. Any transitional tax credits unused at the end of this period will expire.

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To discuss the impact of the Budget on you and your business, please contact your advisor at Goldfarb, Shulman, Patel & Co. LLP.

COMBINED FEDERAL AND ONTARIO CORPORATE TAX RATES

The Budget does not change the Ontario corporate tax rates. The following combined Federal and Ontario tax rates continue to apply to corporations subject to Ontario tax:

		2006	2007	2008	2009	2010	2011
Small business rate on active income up to \$300,000*	Federal	13.12%	13.12%	11.50%	11.00%	11.00%	11.00%
	Ontario	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>
		18.62%	18.62%	17.00%	16.50%	16.50%	16.50%
Small business rate on active income from \$300,000 to 400,000*	Federal	22.12%	13.12%	11.50%	11.00%	11.00%	11.00%
	Ontario	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>
		27.62%	18.62%	17.00%	16.50%	16.50%	16.50%
Manufacturing & processing rate (income not eligible for the small business rate)	Federal	22.12%	22.12%	20.50%	20.00%	19.00%	18.50%
	Ontario	<u>12.00%</u>	<u>12.00%</u>	<u>12.00%</u>	<u>12.00%</u>	<u>12.00%</u>	<u>12.00%</u>
		34.12%	34.12%	32.50%	32.00%	31.00%	30.50%
General rate (active income not eligible for the small business rate)	Federal	22.12%	22.12%	20.50%	20.00%	19.00%	18.50%
	Ontario	<u>14.00%</u>	<u>14.00%</u>	<u>14.00%</u>	<u>14.00%</u>	<u>14.00%</u>	<u>14.00%</u>
		36.12%	36.12%	34.50%	34.00%	33.00%	32.50%
Investment income (other than dividend income from taxable Canadian corporations)**	Federal	35.79%	35.79%	34.67%	34.67%	34.67%	34.67%
	Ontario	<u>14.00%</u>	<u>14.00%</u>	<u>14.00%</u>	<u>14.00%</u>	<u>14.00%</u>	<u>14.00%</u>
		49.79%	49.79%	48.67%	48.67%	48.67%	48.67%

* These rates do not take into account the effect of the clawback of the Ontario small business deduction. The clawback applies where taxable income of the corporation and those corporations associated with it, falls between \$400,000 and \$1,128,519. The Ontario clawback rate is 4.67%.

In addition, the table does not take into account that a corporation's business limit for federal tax purposes is clawed back where the corporation, together with any associated corporations, had taxable capital, as computed for federal Large Corporation Tax purposes, in excess of \$10 million in the preceding year.

The rates are presented on a calendar-year basis. Where a corporation's fiscal year straddles two calendar years, its corporate income tax rate will be pro-rated for the number of days in its fiscal year that falls into each calendar year.

** These rates apply to investment income earned by a CCPC, and include refundable dividend tax of 26.67%.