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PRINCIPAL ISSUES: Tax consequences of payments from the BC Forest Revitalization Trust as a Lost Opportunity Amount to certain eligible contractors as a consequence of the implementation of the Forestry Revitalization Act.  
POSITION: The payments represent proceeds of disposition of a "timber resource property" to the contractors. Consequently, the contractors would include in income under subsection 13(1) any excess of proceeds over UCC of the class.

2) Alternately, the amounts will be taxable under section 9 as compensation for the loss of profits or under subparagraph 12(1)(x)(iii) as an inducement.

REASONS: The contract between the contractor and the licensee meets the definition "timber resource property" in subsection 13(21).

2) Otherwise, under the "surrogatum" principle, the amounts will be taxable as compensation for the loss of an income source. The amounts could also be considered as an inducement for the purposes of paragraph 12(1)(x) as the contractor is obliged to release the licensee from any claims as consideration for the receipt of the amount.

August 28, 2007

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2007-023699

Payments from the BC Forest Revitalization Trust ( the "Trust")

This is in response to your memorandum of May 18, 2007, wherein you requested our views in respect of the taxability of payments received by certain contractors from the Trust. We acknowledge the receipt of various agreements in respect of XXXXXXXXXXXX , a logging contractor that received payments from the Trust.

Unless otherwise noted, all references herein are references to the Income Tax Act.

Our understanding of the pertinent facts is as follows:

In the province of British Columbia ("B.C."), the legal right to harvest trees is granted by way of various types of licences to forest companies (the "licensees") under the Forest Act (British Columbia). Under the Forest Act and the Timber Harvesting Contract and Subcontract Regulation to the Forest Act, the licensees are allowed to use contractors to harvest the timber. The previous Timber Harvesting Contract and Subcontract Regulation (B.C. Reg 22/96) required the licensees to use contractors to harvest 50% of the timber provided that the contracts were renewable in perpetuity. The current legislation (B.C. Reg 278/2004) came into effect on June 21, 2004. Under the current rules, replaceable contracts and subcontracts existing as of June 21, 2004, are grandfathered. About 75 % of the allowable annual cut in BC was committed in long-term replaceable tenures, such as tree farm licences and forest licences.

On March 26, 2003, the government of B.C. (the "Province") announced a new plan to revitalize the forest industry by reallocating 20% of logging rights from major licences and making these rights available through the open market. The Province announced a one time funding of \$ 275 million for the transition: \$ 200 million was allocated to the licensees as compensation for the legal harvesting rights removed from their allowable annual cuts; and \$ 75 million was contributed to the Trust to fund transition assistance to contractors and forest workers.

The Forestry Revitalization Act (the "FRA") was enacted on March 31, 2003. Under the provisions of subsections 2(1) and (3) of the FRA, the allowable annual cut ("AAC") of an ungrouped replaceable licence and the total of the AAC's of replaceable licences held by a corporate group was reduced by 20% with the first 200,000 cubic metres being exempt. Section 6 of the FRA governs the legal right to compensation. A licensee was entitled, as of March 31, 2003, to an amount equal to "the value of the harvesting rights taken".

Background information regarding the Trust

The Deed of Trust dated as of March 17, 2003, was between the Province and the Bank of Nova Scotia Trust Company.

The stated purpose of the Trust is to mitigate adverse financial impacts suffered by an Eligible Person as a result of the restructuring of the forestry sector in BC as a consequence of the implementation of the FRA.

The salient terms of the Deed are as follows:  
(Capitalized terms have the meaning assigned in the Deed)

- \* The Province contributed \$ 75 million to the Trustee.
- \* The Termination Date is the earlier of March 31, 2008 and the date on which there is no remaining Trust Property.
- \* On the Termination Date, the Trustee will transfer any remaining Trust Property to such persons as may be selected by the Trustee.
- \* The Eligible Persons include:

Unemployed Forestry Worker: an employee of a Major Licensee or a Contractor who ceased to be an employee;

Retraining Forestry Worker: an employee of a Major Licensee or a Contractor who is undergoing training in order to learn the duties of an Unemployed Forestry Worker;

Eligible Contractor: a person who was on the Contribution Date the holder of a replaceable contract within the meaning of the Timber Harvesting Contract and Subcontract Regulation of the Forest Act (THC) and who had the amount of work in respect of any replaceable contract reduced under Part 5 of the THC where the reduction is attributable to a reduction in the harvesting rights of a Major Licensee under the FRA.

\* The Trustee maintains 3 separate accounts:

Forest Worker Mitigation Account: \$ 47 million  
Contractor Mitigation Account: \$ 23 million  
Administration Account: \$ 5 million

\* An Eligible Person has no right or entitlement to receive any portion of the Trust income or capital of the Mitigation Accounts or any benefit from the Trust unless and until the Trustee exercises a discretion in favour of that person.

\* Distributions out of the Contractor Mitigation Account:

The Trustee will make a determination of the "Preliminary Base Amount" which represents payments to be made in respect of Contractors operating in the Coast Forest Region and the BC Interior Forest Region.

In order to determine the Preliminary Base Amounts, the following factors are considered: Market values of replaceable harvesting contracts; the expected relative levels of Contractor work reduction; the relative degrees of excess of harvesting capacity in the Coast Forest Region as compared to the BC Interior Forest Region.

The Trustee allocates the Preliminary Base Amounts among the respective Major Licensees according to a formula.

The Trustee may make a payment out of the Mitigation Account if the payment is likely to be of benefit to one or more Eligible Forestry Workers or Eligible Contractors.

\* No portion of the Trust Property may be distributed to the Province.

In 2005, the Province contributed an additional \$ 50 million to the Contractor Mitigation Fund. The Payments from the Trust commenced in 2005. As at December 31, 2005, the holders of XXXXXXXXXXXX replaceable contracts had been compensated in an amount of \$ XXXXXXXXXXXX . As at December 31, 2006, XXXXXXXXXXXX contractors had been compensated in an amount of \$ XXXXXXXXXXXX.

According to the document entitled "Guidelines for major licensees and contractors with respect to the loss of some or all replaceable contracts as a direct result of the Forestry Revitalization Act Timber Reallocation" (the "Guidelines"), a contractor or subcontractor must release the Licensee or contractor, as the case may be, from any claims under the particular contract in order to receive mitigation payments from the Trust.

We have reviewed the following documents relating to XXXXXXXXXXXX , a logging contractor which held XXXXXXXXXXXX replaceable contracts with a licensee, XXXXXXXXXXXX :

a) The "Full Phase Contract" (the "Full Phase Contract") dated XXXXXXXXXXXX , where the work was defined as being 100% of the total amount of timber harvested from XXXXXXXXXXXX (the "Licence") located in the XXXXXXXXXXXX ;

b) The "Dedicated Phase Road Building Contract" (the "Road Building Contract") dated XXXXXXXXXXXX , where the work was defined as being 100% of all road building required to facilitate the timber harvesting operations of XXXXXXXXXXXX within the Licence.

c) A "Notification of Release" (the "Release") dated XXXXXXXXXXXX , between XXXXXXXXXXXX the reduction of work available in the Contract and acknowledging that each of XXXXXXXXXXXX will release the other party from actions arising from the reduction of the Contract.

d) A "Contractor Mitigation Funding Agreement BC Forestry Revitalization Trust" between the Trust and XXXXXXXXXXXX (the "Funding Agreement") dated XXXXXXXXXXXX .

According to the Funding Agreement, the Trustee will pay XXXXXXXXXXXX the following amounts:

\* "Lost Opportunity Amount"

Paragraph 11 of the Funding Agreement states as follows: " The Lost Opportunity Amount is being paid to the Recipient in order to mitigate the following adverse effects:

(i) The Recipient has contractual rights ("Specified Contract Rights") under one or more contracts described in Schedule A to the Funding Agreement.

(ii) The Recipient is unable to exercise the Specified Contract Rights to the same extent as was the case prior to the FRA Restructuring."

\* "Aggregate Specified Sub-Contractor Amount"

This represents a payment to a contractor to be used to compensate sub-contractors for opportunities lost as a result of the restructuring.

\* "Redundant Equipment Amount"

This represents a compensatory payment made directly to the contractor to compensate the contractor for equipment that has been made redundant as a result of the restructuring.

You have advised that XXXXXXXXXXXX received a total amount of approximately \$ XXXXXXXXXXXX as a Lost Opportunity Amount of which approximately \$ XXXXXXXXXXXX was attributable to the Full Phase Contract and approximately \$ XXXXXXXXXXXX was attributable to the Road Building Contract.

You have provided a copy of a submission from XXXXXXXXXXXX ., the representative of XXXXXXXXXXXX , relating to the tax consequences of the payment received by his client from the Trust as a Lost Opportunity Amount.

XXXXXXXXXX

#### Our Comments

You have specifically requested our views in respect of the taxability of the amount received as a Lost Opportunity Amount. You have advised that you are satisfied with the tax treatment of other amounts received from the Trust.

We disagree with the representative's position that amounts received by XXXXXXXXXXXX from the Trust as a Lost Opportunity Amount are a windfall and, therefore, non-taxable.

In the case of FBL, the taxpayer, FBL, was a logging contractor that conducted its operations on Lyell Island, BC, and had a contract with Western Forest Products Ltd ("WFPL"), a forestry company that held a licence with the Province that expired in May 1987. WFPL did not apply for a new licence and consequently FBL ceased its work. On July 1, 1987, the Province terminated all logging operations on Lyell Island in order to construct the "South Moresby National Park" pursuant to a joint project between the Province and the government of Canada (the "Federal Government").

In an agreement dated September 25, 1987, the Province agreed to pay out-of-pocket expenses to FBL incurred as a result of the Province shutting down logging operations on Lyell Island and causing FBL to move its equipment to Vancouver Island. Subsequently, the taxpayer discovered the existence of an agreement between the Province and the Federal Government on the subject of the South Moresby National Park and realized that FBL was excluded from a resulting compensation package. FBL received a legal opinion advising that FBL had no legal right to any compensation from either government but could instead pursue a moral claim. The South Moresby Compensation Committee rejected all further claims submitted by FBL other than out-of-pocket expenses. FBL obtained a report from a Chartered Accountant firm advising that the value of the interest of FBL in the logging business through the contracts held with WFPL was approximately \$ 12 million. After hiring lobbyists and undertaking a series of meetings with various government officials, FBL received the sum of \$ 800,000, and signed a release foregoing any legal action against the Province and the Federal Government. FBL did not include the amount of \$ 800, 000 in income on the basis that the amount was a non-taxable windfall.

While there are certain similarities between the FBL case and this situation, we note the following significant differences:

\* In the FBL case, while the taxpayer made organized efforts to receive compensation, the taxpayer was refused compensation and had received legal advice that they would not be successful in a lawsuit against the Province. Therefore, the taxpayer had no expectation to receive any compensation.

Watson, D.J. said on page 1405:

"The appellant had no reason to expect - as opposed to hope for - any such payment."

In this situation, we assert that the Province settled the Trust on March 17, 2003, for the purpose of mitigating adverse financial impacts suffered by eligible contractors as a result of the restructuring of the forestry sector as a consequence of the implementation of the FRA. As of this date, these

contractors had a specific expectation (albeit not an enforceable right) to receive some compensation for the loss of their replaceable contractual rights as a result of timber reallocations resulting from the FRA. Furthermore, the licensees were required, under the legislative provisions of the previous THC, to use contractors to harvest 50% of the timber. In particular, with respect to XXXXXXXXXXXX , the contracts were entered into on XXXXXXXXXXXX , at which time the licensee, XXXXXXXXXXXX , was obliged, under the legislative provisions of the existing THC, to use contractors to harvest 50% of the timber. Therefore, it is reasonable to conclude that XXXXXXXXXXXX had an expectation to receive compensation for the loss suffered as a result of the FRA as of March 17, 2003.

\* The amount received by FBL of \$ 800,000 bore no relation to the value of the foregone contracts of \$ 12 million.

We observe that the distributions from the Contractor Mitigation Fund are partly based on the market value of the replaceable contracts. Consequently, unlike the FBL case, the amounts received by the Contractor from the Contractor Mitigation Fund bear some relation to the value of foregone contracts.

\* There was no direct or indirect business relationship between FBL and the Province. FBL's contract with WPFL was terminated as a consequence of the expiration of WPFL's licence in May 1987.

We would suggest that, while there was no direct relationship between the Province and XXXXXXXXXXXX , there was an indirect relationship between them as a consequence of the legislative provisions of the THC. The loss of certain logging rights by XXXXXXXXXXXX as a result of the implementation of the FRA by the Province resulted in a loss by XXXXXXXXXXXX in respect of its contracts with XXXXXXXXXXXX .

\* With respect to the release signed by FBL, Watson, D.J. stated as follows on page 1401: "It is apparent that the release was structured in accordance with usual practice and did not, in any way, contemplate any consideration being given by FBL in the form of foregoing any opportunity-- "

With respect to XXXXXXXXXXXX , we note that paragraph 3 of the Release provides as follows:

XXXXXXXXXX

The terms of the Release make it clear that XXXXXXXXXXXX received the payment from the Trust in consideration for the reduction of the contract and in consideration for XXXXXXXXXXXX releasing each other from any claims in respect of this reduction.

Moreover, as noted above, pursuant to the Guidelines, a contractor must release the Licensee from any claims under the particular contract in order to receive mitigation payments from the Trust.

In addition, the Court in the FBL case did not consider whether the amount received could be considered to be proceeds of disposition for a timber resource property.

In view of the foregoing, it is our position that the amount received as a Lost Opportunity Amount was not a windfall and was taxable to XXXXXXXXXXXX .

As described in more detail below, it is our view that these amounts should be included in the contractors' income as one of the following: proceeds of disposition of a "timber resource property"; under section 9 where it is intended to compensate for lost income; or as a taxable capital receipt where the amount is intended to compensate for the destruction or material crippling of the profit making apparatus of the business; or an inducement for the purposes of paragraph 12(1)(x).

#### Timber Resource Property

A "timber resource property" is defined in subsection 13(21) to include a right or licence to cut or remove timber from a limit or area in Canada if that right is acquired after May 6, 1974 and, at the time of acquisition of the original right, the taxpayer may reasonably be regarded as having acquired, directly or indirectly, the right to

- (a) extend or renew the original right, or
- (b) acquire another such right or license in substitution therefor,

or the taxpayer may reasonably expect, at the time of acquisition of the original right, to be able to extend or renew that right or to acquire another right or license in substitution therefor in the normal course of events.

A timber resource property is depreciable property and is included in class 33 of Schedule II of the Regulations. It is distinguishable from other capital property in that any proceeds of disposition in excess of its capital cost do not result in a capital gain by virtue of the exclusion provided by subparagraph 39(1)(a)(iv), and any proceeds of disposition, including any amount in excess of its capital cost, are credited to the undepreciated capital cost of the class pursuant to element G thereof, which may give rise to an income inclusion under subsection 13(1).

The Full Phase Contract (the "Contract") is in respect of XXXXXXXXXXXX (the "Licence") and has the following relevant terms and conditions:

- It has a term of 5 years ending on XXXXXXXXXXXX .
- Pursuant to section 5, provided that XXXXXXXXXXXX has satisfactorily performed under the Contract, XXXXXXXXXXXX shall offer a replacement contract.
- The specified amount of work under this Contract is in respect of 100% of the total amount of timber harvested from the Licence each year.

Although the contract that we reviewed expired on XXXXXXXXXXXX , we understand that XXXXXXXXXXXX agreed to renew the contract, for an additional 5 years, on substantially the same terms.

It is our opinion that the Full Phase Contract meets the definition of a "timber resource property" as it is a renewable contract and pursuant to the terms thereof, XXXXXXXXXXXX had the right to harvest 100% of timber from the Licence for a period of 5 years and, in the normal course of events, XXXXXXXXXXXX may reasonably be regarded as acquiring another right in substitution therefor.

XXXXXXXXXX

We note that paragraph 11 of the Funding Agreement states that the Lost Opportunity Amount is being paid because the recipient is unable to exercise the contract rights to the same extent as was the case prior to the FRA restructuring. Accordingly, it is our view that the payment of approximately \$

XXXXXXXXXX received by XXXXXXXXXXXX from the Trust that is attributable to the Full Phase Contract will be "proceeds of disposition" of a timber resource property by virtue of paragraph (e) of the definition of "proceeds of disposition" in subsection 13(21) as this amount represents compensation for property injuriously affected, whether lawful or unlawful or under statutory authority or otherwise. Consequently, this transaction resulted in a disposition of a timber resource property pursuant to paragraph (a) of the definition "disposition" in subsection 248(1). XXXXXXXXXXXX will be required to include in income under subsection 13(1) any excess of the proceeds of disposition over the undepreciated capital cost of the timber resource property.

In our view, the payment of the \$ XXXXXXXXXXXX received by XXXXXXXXXXXX that is attributable to the Road Building Contract will represent compensation for the loss of future profits and should accordingly be included in income under section 9, unless the payments are intended to compensate XXXXXXXXXXXX for any loss resulting from the destruction or crippling of its profit making apparatus. In this regard we cite the following cases as support for income treatment: The Queen v. Mohawk Oil Co. Ltd. 92 DTC 6135 and Canadian National Railway Company v. MNR 88 DTC 6340. In addition, Canadian courts have generally relied on British jurisprudence in making the determination of whether a payment is on income account. British case law indicates that the basic principle for purposes of making such determination is to look at the character of the receipt from the point of view of the recipient. See, for example, Murray (Inspector of Taxes) v. Goodhews, [1978] 2 All E.R. 40 (C.A.).

However, if it can be shown that the payments are intended to compensate XXXXXXXXXXXX for any loss resulting from destruction or crippling of XXXXXXXXXXXX 's profit making apparatus, such amount would be considered on account of capital. (See Woodward Stores Ltd. v. MNR, 1CTC 233 and T. Eaton Company Limited v. The Queen, 99 DTC 5178). A compensation receipt which is on account of capital could be considered as received on account of capital in respect of the business carried on for the purposes of element E in the definition "cumulative eligible capital" in subsection 14(5). In this regard we note that for amounts receivable before May 1, 2006, the so-called "mirror image test" in subsection 14(5) will be applicable.

Alternative positions

Section 9

Although we believe that the payment of \$ XXXXXXXXXXXX attributable to the Full Phase Contract represents proceeds of disposition of a timber resource property, we believe that, as our secondary position, this amount should be included in XXXXXXXXXXXX 's income under section 9 as compensation for loss of profits as described above unless you believe that the payment was intended to compensate XXXXXXXXXXXX for any loss resulting from destruction or crippling of XXXXXXXXXXXX 's profit making apparatus.

An inducement for the purposes of 12(1)(x)(iii)

The Lost Opportunity Amount meets the preamble of paragraph 12(1)(x) and the requirements of subparagraph 12(1)(x)(i), since XXXXXXXXXXXX received the Lost Opportunity Amount in the course of earning income from a business and the payments are from a person, the Trust, in circumstances where it is reasonable to conclude that the Trust would not have paid the amount but for the receipt of the amount from a government.

The issue is whether the Lost Opportunity Amount will meet the requirement of subparagraph 12(1)(x)(iii) i.e. "an inducement, whether as a grant, subsidy, forgivable loan, deduction from tax, allowance or any other form of inducement".

While the term "inducement" is not defined in the Act, it normally implies the receipt of something as an award or compensation for doing something in the course of earning business income.

The definition of "inducement" in the Shorter Oxford Dictionary:

"That which induces; something attractive by which a person is led on or persuaded to action."

In the 1994 Tax Court of Canada decision of Supermarché Ste- Croix v. the Queen, Lamarre Proulx, J. said:

"An inducement payment is always granted in consideration of an obligation on the recipient's part."

As stated above, pursuant to the terms of the Release, XXXXXXXXXXXX agreed to the payment from the Trust in consideration for the reduction of the Contract and, furthermore, XXXXXXXXXXXX agreed to release each other from any claims under the Contract in respect of the reduction of the Contract. Consequently, it is arguable that the Lost Opportunity Amount represents an inducement for the purposes of paragraph 12(1)(x) as XXXXXXXXXXXX was obliged to act in a certain manner as consideration thereof.

If you have any questions, please contact the writer.

Yours truly,

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