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BC Forestry Revitalization Trust

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David Lewis
Executive Director
Truck Loggers Association
725-815 West Hastings Street
Vancouver, BC
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Dear David Lewis

Re: Mitigation Payments from the BC Forestry Revitalization Trust (BCFRT)

As requested, I write further to our earlier discussions about the nature of the mitigation payments made by the BCFRT to replaceable contractors.

This letter summarizes my understanding of a technical interpretation (the “**TI**”) received by me from the Income Tax Rulings Directorate of the Canada Revenue Agency (the “**CRA**”), other documents issued by the CRA and my understanding of other points of view as to the status of mitigation payments for Canadian income tax purposes. The TI issued to me by the CRA is not binding on the CRA (it is not an advance income tax ruling).

This letter should not be construed as tax advice. Your membership should rely on their own tax advisers before making any decisions related to how they treat funds they receive from the BCFRT.

There are three different possible payments that can flow to a replaceable contractor from the BCFRT, as follows:

1. **Employee Mitigation payments.** These payment are made to replaceable contractors and licensees to offset the out of pocket cost of severing harvesting employees made redundant by the loss of contract volume. None of these funds stay with the contractor or licensee. Rather, all these funds flow through the employer to the benefit of the employee.

The TI takes the position that these payments must be included in the income of the recipient contractors and licensees pursuant to paragraph 12(1)(x) of the *Income Tax Act* (the “**ITA**”). However, the licensees and contractors would then be able to deduct the severance payments as expenses of doing business so that the net income inclusion is nil. Alternatively, the licensees and contractors may avoid the income inclusion by electing to reduce the deductible amount of the severance payment

pursuant to section 12.2 of the ITA (same effect of nil net income inclusion). In respect of the section 12.2 election, the TI referred to paragraphs 2 and 3 of Interpretation Bulletin IT-237R2.

Of course, the TI does not address the tax position of the employee.

Another view is that the BCFRT is merely reimbursing the employer for the costs of severance, so the employer has no net expense.

In any event, I think that it is generally acknowledged that the employees will be subject to income tax on the severance payments (except to the extent that income tax can be deferred by having the severance paid directly into a Registered Retirement Savings Plan (RRSP), either under the retiring allowance rollover provisions of the ITA, or because the employee has unused contribution room available). I think that it is also generally acknowledged that the employer will be responsible for withholding income tax source deductions at the prescribed rates for retirement allowances (to the extent that the RRSP direct transfer rules do not apply).

2. **Contractor Mitigation payments for loss of replaceable contract volume.** The BCFRT does not buy the contract, and there is no negotiation between a willing buyer and a willing seller. Rather, when the contractor applies for compensation, the contract has already been reduced or eliminated through the operation of an implemented Forestry Revitalization Proposal.

In the TI, the CRA takes the position that the receipt of funds for loss of volume should also be treated as income under paragraph 12(1)(x) of the ITA. This is subject to the contractor or licensee making an election under section 12.2 of the ITA to reduce the related outlay or expense. In respect of the section 12.2 election, the CRA referred to paragraphs 14 and 15 of Interpretation Bulletin IT-237R2.

The TI went on to state that a specific payment might be a capital receipt in some circumstances if the contract in question formed a significant part of the business of the contractor or licensee. The TI added that the CRA usually viewed compensation received for cancellation of a trade contract as being on income account.

I am informed that some companies have been audited by the CRA and that the CRA auditor has accepted this class of mitigation payments as a capital receipt. I do not know which companies may have been treated in this manner or whether the auditor treated the amount as a taxable capital receipt or as a tax-free capital windfall.

At the 2004 British Columbia Tax Conference of the Canadian Tax Foundation, Ian Gamble presented a paper entitled “Resource Industries – Selected Developments: Mining and Forestry”. He discussed the BCFRT at the end of that paper and took the position that payments made by the BCFRT would not constitute income from a source and so would constitute a windfall. He cited the *Frank Beban Logging*¹ and

¹ 98 DTC 1393 (TCC).

*Fries*² cases in support of this proposition. Mr. Gamble pointed out that an exception could apply if an amount could be regarded as having been received in respect of the specific cost of a particular property or in respect of a particular outlay or expense (as opposed to a unitary sum that cannot be traced to a specific cost or expense).

On August 28, 2007, the CRA issued document 2007-0236991I7 (available as part of the CRA database). This is a memorandum from CRA Headquarters to (presumably) a CRA local office. The document deals with the taxation of payments received by specific contractors (identifying information has been deleted from the document). In that document, the CRA considers representations received from the advisers of the contractors in question. The CRA rejected the windfall argument and concluded that the amount was taxable on three alternative basis: as proceeds of disposition of a timber resource property, as general income under section 9, or as an inducement payment under section 12(1)(x).

- 3. Contractor Mitigation payments to help offset the costs of selling equipment made redundant by the loss of replaceable contract volume.** The BCFRT will pay a 25% premium over the arms length sales price of redundant equipment. The intent here is to help offset transaction costs, which may include sales commissions, moving the equipment to auction or a used equipment dealer, and repairs to make the equipment saleable.

In the TI, the CRA takes the position that these payments are tied to the cost of the equipment and would be included in income pursuant to paragraph 12(1)(x) of the ITA unless the taxpayer elects to reduce the cost of the related equipment under section 13(7.4) (in respect of the undepreciated capital cost of depreciable property) or section 53(2.1) (in respect of the cost of non-depreciable capital property).

Another view is that the payment should be added to the proceeds of disposition of the assets in question and therefore should be treated either as recapture of capital cost allowance or as a capital gain.

The above information is given only to help show the issues that your members might consider when filing their tax returns. It is not tax advice and cannot be relied upon as such. Each contractor is strongly encouraged to seek advice from its own advisers. I have no issue with a contractor showing this letter to its adviser in order to provide additional background to the adviser.

Yours truly,

Eric van Soeren
Trustee

² [1990] 2 CTC 439 (SCC).