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Economic Instruments

Economic Instruments Available to the Federal Government to Encourage Economic Sustainability on Private Woodlots

**Discussion Paper prepared for the
National Round Table on the Environment and the Economy**

**Economic Instruments to Encourage Sustainability on
Private Lands Workshop**

October 22, 1997

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Preface

This discussion paper is an overview of the various economic instruments available to the federal government to encourage sustainability on private woodlots. The paper addresses the need for income tax reform in the context of private woodlot management and reviews the recommendations advanced by various stakeholders.

This paper will form part of the basis for discussion at the Greening the Budget 1998 Workshop: Economic Instruments to Encourage Sustainability on Private Lands, sponsored by the National Round Table on the Environment and the Economy (NRTEE). Various stakeholders at the Workshop are to discuss the issue of private woodlot management in Canada and incentives that might be included in the federal government's 1998 Budget. Following the workshop, NRTEE expects to make specific recommendations to the Finance Minister.

To prepare this paper, the authors relied on the following principal sources of information:

- *State of the Debate on the Environment and the Economy: Private Woodlot Management in the Maritimes*, National Round Table on the Environment and the Economy, September 1997.
- *Tax Reform for Private Woodlot Owners in Canada*, Canadian Forestry Association, May 1992.
- Resolutions adopted by representatives of *La Fédération des producteurs de bois du Québec*.
- Consultations held with *Mr. Peter deMarsh*, President of the Canadian Federation of Woodlot Owners.
- Consultations held with relevant officials in the federal government.

Background

NRTEE established the Private Woodlot Harvesting Program to examine key issues affecting the sustainability of current harvesting practices and levels in Canada's Maritime provinces. Over the past 18 months, NRTEE held consultations with major stakeholders and experts and conducted research on current practices and management initiatives already under way within industry and government.

These stakeholders agree that the lack of sustainable practices on private woodlots has had, and will continue to have, negative economic, social and environmental consequences.

Generally speaking, poor management practices on private woodlots, with the negative impacts, are not restricted to the Maritime provinces.

The consultations revealed that there are numerous reasons for the poor management practices and that to resolve these issues will involve a coordinated effort from many interested parties. Two of the problems that the federal government can help to resolve are

- the absence of financial incentives for owners to make proper decisions in the context of sustainable development; and
- the lack of funding for research and development and silviculture programs.

One of the recommendations coming from the consultation process was that the federal government reform the tax system so that it no longer operates as a strong disincentive to sustainability. Another recommendation was that the federal government continue to provide scientific research and collect data through such national bodies as the Canadian Forestry Service. This paper reviews the proposed fiscal initiatives.

Introduction

In Canada, forest management is within provincial jurisdiction, which allows each province to have its own legislation, regulations and policies governing forest activities within its borders. The federal government does play a role in forest management in that it has responsibility for international trade, environmental regulation, Aboriginal affairs, and taxation.

In Canada today, about 6% of forest land is private property. A significant proportion of this is held by small, private woodlot owners. For the most part, these woodlot owners are Canadian residents, living on or near their woodlot properties.

Governments do not regulate the harvest of timber on most private lands; the level of logging is determined solely by individual owners, based on market conditions of supply and demand and the owners' personal objectives. In short, there are no regulations to require woodlot owners to manage private woodlots in environmentally sustainable ways. Moreover, the federal monies devoted to encouraging sustainable development of private woodlots evaporated after Ottawa canceled the Forest Resource Developments Agreements with the provinces. Since then some Maritime provinces have initiated programs designed to pick up some of the responsibility for encouraging the sustainable management of private woodlots. Notwithstanding these provincial initiatives, private woodlots in these provinces, as well as others across the country, continue to face serious challenges to environmentally sustainable management.

The Economic Rationale for Federal Support

The need for income tax reform for private woodlot owners has long been recognized. Many reports throughout the 1980s and 1990s called for reform — the calls have remained largely unanswered, despite the fact that tax reform may be a simple, inexpensive way for the federal government to stimulate sustainable development on Canada's woodlots. Further, the federal government has an obvious interest in

encouraging the sustainable use of this valuable national resource.

Woodlot owners are not managing this resource in a socially responsible way because the private market is sending them insufficient information. In fact, the woodlot owners are underproducing because they do not recognize (or benefit from) the externalities, or spillovers, that benefit the public. These externalities come in the form of oxygen production, carbon dioxide storage, and biodiversity. Each has benefits to the whole of society.

At present, however, the woodlot owners benefit only from the commercial value of the cut wood, not from those broader social benefits generated in the production and maintenance of timber. It is therefore appropriate to use the federal consolidated revenue fund to promote activities to tap these benefits. Generally speaking, it is proposed that the Government

of Canada purchase those social benefits on behalf of all Canadians. But what is the estimated social value of these externalities? If we knew this, we could determine how much to spend through federal tax expenditures and other direct federal spending.

The Target Group

Although the policy rationale outlined above applies in principle to all forests, even publicly owned forests, the actual target group for tax incentives would not include all private forests. In its "State of the Debate Report," NTREE defined a private woodlot as a privately owned piece of land used for growing forest trees, or suitable for growing trees. A private woodlot is not owned by a large corporation for use in commercial forestry. Private woodlots may or may not be used as a source of revenue.

Productive Forest Areas, 1990

	Total Provincial Inventoried Productive Forest Area (000 ha)	Total Woodlot Productive Forest Area (000 ha)	Woodlot Productive Area as a % of Provincial Total	No. of Woodlot Owners
Nfld.	11,480	51.9	0.46	4,500
P.E.I.	280	257.4	91.93	16,000
N.S.	3,850	1,865.5	48.45	31,000
N.B.	6,090	1,955.6	31.78	35,000
Que.	54,790	6,185.6	11.29	120,000
Ont.	58,290	4,865.0	8.71	169,000
Man.	14,920	990.0	6.64	3,500
Sask.	15,390	389.5	2.45	15,000
Alta.	25,440	983.4	3.67	7,500
B.C.	51,100	1,961.6	3.84	21,000
Total	221,330	19,435.5	8.76	422,500

Source: Forestry Canada, *Private Woodlots in Canada*, Discussion Paper (1991)

The proposals outlined in this report are not simply designed to increase the number of trees under private cultivation, although this is expected. Rather, the proposals are designed to promote better, more sustainable management of private woodlots.

The Key Initiative

The *Income Tax Act* fails to recognize woodlot owners as a distinct group and fails to recognize the business of managing a woodlot as an activity requiring specific tax treatment. In many instances, the woodlot owners fall under the general category of farmers, but most of these owners do not qualify for the beneficial tax treatment available to farmers because they are considered part-time farmers. However, woodlot management, whether or not it is done on a part-time basis, can have a significant impact on the long-term sustainability of the woodlots.

Recommendation — Create a separate category for woodlots and woodlot owners, to be used to determine eligibility for the specific incentives.

Considerations — This is a general recommendation that will facilitate the implementation of the specific recommendations to follow. This initiative is the gatekeeper that gives access to the specific incentives and in large part forms the key to encouraging sustainable development. It speaks to the need to define *sustainable woodlot operation* to enable tax policy to target those operations.

The proposal is that only operations following a reasonable woodlot-management plan would qualify for beneficial treatment. The indicator might be the owner's participation in woodlot-management education.

This recommendation raises a number of questions: Who is to develop this woodlot-management plan? What is to be in it? Who is to certify it? What type of educational requirements should there be, and who

should administer them? Who is to monitor its implementation and maintenance over time? Is there an annual inspection? What does it cost, and who pays for it? Does it significantly raise operating costs for some operators, making operations unfeasible?

The "Curtis Report on Tax Reform for Woodlot Owners" first made this recommendation in 1992 but recognized that "it will take a considerable amount of time before all interested woodlot owners will be able to obtain even a basic management plan for their woodlots." It is unclear how much — if any — analysis or advance has been made since.

These questions will be the first ones raised by the Department of Finance. They will need to be answered for a number of reasons, not the least of which is to estimate the expected take-up of the tax incentives and thus to get an estimate of their cost to the federal treasury. The take-up will also determine the impact on the objective of achieving sustainability.

There would also be an additional cost to the federal government, most likely Revenue Canada, to cover certification, monitoring and enforcement. Alternatively, if the provinces are to be responsible for certification, the federal government may have some concerns about a program that depletes their revenues but is not entirely under its control.

It should be noted that this recommendation represents a shift from one of the fundamental principals of the tax system — the "reasonable expectation of profit test" — and can therefore be expected to meet with serious resistance from Finance officials.

Recommendation for NRTEE discussion — The workshop should further develop the concept of a reasonable woodlot-management plan in terms of administration and qualifying criteria and should analyze the cost to various woodlot owners of meeting the new criteria.

Specific Federal Incentives

This section outlines the specific recommendations advanced over the years and the issues surrounding them.

1. Deductibility of Expenses and Losses

To decide whether certain losses from farming operations are deductible from income and what restrictions apply to the ways they are deductible, Revenue Canada first determines under which of three categories a taxpayer falls:

- Where farming or a combination of farming and some other source of income is the chief source of income, the farmer may deduct the full amount of the farm loss in the year of the loss against other income.
- Where farming or a combination of farming and some other source of income is not the chief source of income but the farmer operates the farm with a reasonable expectation of profit, the farm loss may be deducted in the year of the loss against other income.
- Where farming or a combination of farming and some other source of income is not the chief source of income and the farmer operates the farm without a reasonable expectation of profit, the farm loss may not be deducted against other income.

Because most private woodlot owners tend to fall under category B (part-time farmers), they are subject to the “restricted farm loss” rules, which may prevent the full deduction of losses in the year of the loss. For example, if the net farm loss is \$15,000 or more, the woodlot owner can deduct \$8,750 from other income. The rest of the farm loss is restricted farm loss, which can be carried back (3 years) or forward (up to 10 years) but deducted only against farm income.

If a private woodlot owner is carrying on a business without a reasonable expectation of profit, the expenses related to the extent of losses are seen as personal and living expenses, which are specifically disallowed under the Act.

The problem for woodlot owners is that revenues and expenses can vary from year to year. Although forest production is spread out over a number of years, the harvest is usually carried out over a short period of time, so the revenues are very concentrated.

Many private woodlot owners are forced to operate without being certain which expenses will be deductible.

Recommendation — Revenue Canada should allow deductions against any income for all admissible expenses incurred for forest management, without restriction on the amount of losses, and with provision to allow losses to be carried forward to years when they can be used to offset income.

Considerations — Essentially, all businesses are subject to the “reasonable expectation of profit tests” when deducting expenses. A specific tax benefit for woodlot owners might result in a flood of other groups seeking similar preferential treatment. The potentially substantial lost tax revenues, due to permissible expenses, might not necessarily be under federal control. Further, the potential for abuse through the bunching of expenses would be a major deterrent abuse.

Recommendation for NRTEE discussion — The workshop should decide what restrictions should apply to expenses to make the proposal less open-ended.

2. Cash-Basis versus Accrual-Basis Accounting

Most taxpayers engaged in a business must use the accrual method to calculate income and expenses. Farmers and fishers may use the accrual method but also have the option of using the cash method.

With cash-basis accounting, income includes only amounts actually received in the year, and expenses include only amounts actually paid in the year. With the accrual method, Revenue Canada recognizes revenues and expenses as they are incurred, rather than actually paid or received.

Cash-basis accounting is currently unavailable to woodlot managers whose operations are not considered farming or as being associated with farming. However, cash-basis accounting is better suited to the business of woodlot management because of the time involved between incurring expenses and generating revenues.

Recommendation — Revenue Canada should extend the option of cash-basis accounting, currently available for farming and fishing, to include woodlot management.

Considerations — Farmers and fishers are the only group of taxpayers currently allowed to use either accounting method. The tax break, if any, is intended to benefit the “full-time” farmer. The likely response from the government is that woodlot owners are eligible for this benefit, provided they meet the definition of farmer as currently defined in the Act. Again, the potential for abuse through bunching expenses would be a major concern of the government.

Recommendation for NRTEE discussion — A reasonable definition of “operations that are following a reasonable woodlot-management plan”, as discussed in “The Key Initiative” above, might also be used to determine who may qualify to use cash-basis accounting. Analysis of the number of taxpayers who would qualify and the impact this would have on their tax owing would be useful.

3. Depletion Allowance for Timber

Woodlots may qualify for a depletion allowance, which is essentially a type of capital cost allowance. A capital cost allowance is a deduction against income in recognition that certain capital assets used by a taxpayer to generate income depreciate over time.

The depletion allowance for timber is based on the amount of timber harvested in the relevant year. The allowance therefore depends on whether the taxpayer actually cuts the timber.

The current approach to calculating this depletion allowance is inconsistent with the long-term nature of

woodlot management. Because of the requirement that the allowance only be claimed after the timber is cut, a taxpayer may get no tax relief for the significant cost of the standing timber for a considerable time.

Recommendation — Revenue Canada should allow woodlot managers to claim a deduction for the cost of standing timber in the year of acquisition of a woodlot.

Considerations — The government’s response will likely be to argue that the timber stand is a non-depreciating capital asset because its actual value increases with time. Given that no income is realized until the timber is cut and sold, the current rules provide for a more appropriate matching of income and expenses. Although certain other assets that appreciate over time, such as rental buildings, can be subject to a capital cost allowance over time, these assets usually generate income during the period in which the allowance is claimed.

One of the concerns is that the woodlot owner risks the loss of timber to fire, insects, disease or other causes unrelated to harvesting but no allowance for depreciation will have been made. Given this, it may be appropriate to have a federally supported insurance program for woodlot owners, similar to crop-insurance programs currently available in the farming sector.

Recommendation for NRTEE discussion — The workshop should develop a plan for a federally funded insurance program to be available to woodlot owners to cover losses arising from specific perils and should also analyze the extent of the problem.

4. Sales of Timber — Income versus Capital

A farmer’s proceeds from the sale of timber are most often taxable as ordinary income. However, if a farmer with a woodlot permits other persons to remove standing timber, the amounts received are considered to be on account of capital. This amounts to more beneficial treatment because the proceeds serve to reduce the adjusted cost base of the land, but they are not immediately taxed (assuming that the adjusted cost

base remains positive). When the land is sold, the seller pays capital gains tax, at a lower rate than that applied to ordinary income, on the amount that the proceeds of sale exceed the seller's adjusted cost base.

A one-time receipt of revenue from timber cutting may also be treated as a sale on account of capital, which again means that it is only taxable when the land is sold, to the extent that the proceeds of sale exceed the seller's adjusted cost base.

The application of the rules relating to one-time sales of stumpage incidental to the farming operation may encourage poor forestry practices because of the more favourable tax treatment. The workshop must avoid suggesting anything to encourage once-in-a-lifetime liquidations, unless these are in keeping with good forestry practices.

Recommendation — Revenue Canada should permit woodlot owners to elect between income or capital treatment for sales of timber.

Considerations — Revenue Canada has traditionally taken the position that it will look to the intention and nature of the purchase to determine whether it is income or income on account of capital. A one-time sale of stumpage that is incidental to farming is likely not in the nature of trade and is therefore more appropriately treated as capital income. However, a partial solution to this problem may be to more consistently apply the rules, an objective achievable through discussions and negotiations with Revenue Canada.

Recommendation for NRTEE discussion — The workshop should discuss and define the inconsistent application of Revenue Canada's current policy and determine how this issue could be resolved through better communication with Revenue Canada officials.

5. Old Age Supplement

Net income from woodlot harvests may serve to reduce the Old Age Pension Supplement, which may in turn prevent the timely harvest or management of a woodlot. If the taxpayer's net income exceeds certain

limits and the taxpayer has received income from Old Age Security (OAS), then he or she may have to repay a portion of the income amounts. If the taxpayer receives and OAS pension and his or her net income before adjustments is greater than \$53,215, it may be necessary to repay part of the benefits received. Some woodlots have deteriorated because this clawback led their owners to neglect timely harvesting and management.

Recommendation — Revenue Canada should exclude one-time stumpage-sale receipts from the income base used to calculate eligibility for the supplement.

Considerations — OAS is a universal benefit available to all Canadians, and the clawback rules apply equally to all Canadians. To get specific tax treatment for woodlot owners through OAS would therefore be difficult.

Recommendation for NRTEE discussion — The workshop should determine the extent of the problem in terms of the number of present woodlot owners who qualify for OAS.

6. Capital Gains Treatment on Disposition

The \$500,000 capital gains exemption on the sale of farm property continues despite cancellation of the \$100,000 general personal exemption. However, the farm property must meet the definition of qualified farm property, which essentially requires that the land has been used by the taxpayer in the course of carrying on the business of farming in Canada. Because most woodlot owners are not considered as being in the business of farming, the capital gains exemption on the disposition of "qualified farm property" is unavailable to them. Woodlot owners are therefore not encouraged to transfer their property to a child in the same way that farmers are.

Recommendation — Revenue Canada should allow capital gains realized upon the disposition of a managed woodlot to be considered under the \$500,000 lifetime capital gains exemption and further provide for the deferral of any other capital

gains tax payable for intergenerational transfers of farm property.

Considerations — At present, farmers are the only taxpayers afforded this benefit, so to qualify for this benefit, a taxpayer must meet the definition of *farmer*, which means that either farming or a combination of farming and some other source of income is the chief source of income.

Recommendation for NRTEE discussion — Again, drawing on the discussion in “The Key Initiative”, the workshop should develop a clear and concise definition of properties that would qualify for this benefit and should also analyze the issue of the size and value of such properties.

7. Investment Tax Credits

An investment tax credit allows a taxpayer to recover a percentage (in some cases 100%) of certain qualifying expenditures. At present, no investment tax credits are available for woodlot management.

There are limited investment tax credits available if a taxpayer has purchased certain qualifying buildings or equipment for use in the Atlantic provinces or the Gaspé region of Quebec; however, many of the costs of woodlot management are for land, labour and services without credits, even in the designated areas.

Having been aggressively harvested, many woodlots require investments for rehabilitation. Investment tax credits could be used to encourage the required investment in woodlot management.

Recommendation — Revenue Canada should establish tax credits to make it more attractive for woodlot owners to purchase woodlot and to invest in woodlot management and related machinery and equipment.

Considerations — This proposal could prove very effective in encouraging certain environmentally sustainable activities. Concerns respecting cost (which would depend on the size and extent of the credits) and enforcement need to be addressed.

Recommendation for NRTEE discussion — The workshop should develop proposals for specific tax credits in terms of the expenditures that would qualify for the credit, as well as the percentage of expenditure that would be eligible.

8. Registered Forest Management Fund

Expenditures on forest management can be spread out over a number of years and do not necessarily correspond to revenues, which makes it difficult to match forest management expenses to revenue. The Act provides no mechanism for woodlot managers to shelter from taxation any portion of income to be used for woodlot management. Establishing such a mechanism for woodlot owners would provide for a better flow of income and expenses.

Recommendation — Revenue Canada should allow woodlot owners to shelter income invested within a reasonable time in forest management.

Considerations — This should be seen as one of the more reasonable recommendations. However, tight rules would be needed to control abuses and ensure that sheltered funds are actually used for forest management.

Recommendation for NRTEE discussion — The workshop should develop rules to determine where and when the funds should be sheltered. The proposal needs to provide for a clawback of tax owed if the funds are not ultimately used in the prescribed time for the intended purpose.

9. Government Funding

Both the federal and provincial governments clearly need to work closely with industry to strengthen knowledge and technology transfers, which have suffered after the demise of the Forest Resource Development Agreements.

Recommendation — The federal government should be encouraged to maintain its capacity to provide scientific research and collect data through such bodies as the Canadian Forestry Service.

Considerations — Given the government's improving fiscal position, now may be the appropriate time to request funds to be used in large part to replace programs previously funded by the federal government.

Recommendation for NRTEE discussion — The workshop should develop the proposal in terms of the type of programs that various stakeholders would like to see and should also decide who would be involved in the ongoing administration of these programs.

Conclusions

The need for tax reform in the woodlot sector is clear. What is not so clear is the manner of reform. The issues of cost and economic impact require further analysis to determine which proposals are feasible and which will have the most impact in favour of sustainable development. Taken as a whole, the proposals amount to the industry's request to be treated in the same way as farmers and fishers, although in some cases the industry is asking for more beneficial treatment.

The proposal for specific categories of "woodlot management" and "woodlot owner" needs to be further developed and analyzed in terms of the cost to industry, the likelihood of industry participants being involved in the implementation, the impact on sustainable development, and the government's cost and administration of such a program.

A general concern about the package of proposals is that they may ultimately encourage concentration of private woodlots in the hands of a few taxpayers with non-woodlot income to shelter. This may be inconsistent with other policy objectives of the federal and provincial governments.

Finally, it should be noted that most of the specific proposals are directed to decreasing the tax woodlot owners pay on their profits. Small incorporated businesses are subject to an average effective federal tax rate of roughly 8 to 10%, and unincorporated businesses pay, on average, 16%. These are not high taxes. Therefore, more relief may be obtained for woodlot owners by looking at taxes other than those on profits, including payroll taxes (which are federal and provincial) and property taxes (which are provincial-municipal).

Other - GST.