

## **Government Compensation Agreements**

With the advent of government policy towards settling a number of provincial and federal land use and Crown land tenure issues, small and large Crown land tenure holders and their contractors are facing adverse tax consequences arising out compensation agreements for expropriations by government. In addition, the federal government has announced special funding for communities impacted by economic trade issues. These trade issues have caused economic and employment crises in communities that produce lumber for U.S. markets and for those involved in automobile and other manufacturing. At the present time, however, there is confusion and inconsistent application by the Canada Revenue Agency as to how such compensation agreements or special funds are to be taxed in the hands of recipients.

As an example, in 2005, the BC Government enacted Bill 28 as part of its Forest Revitalization Plan (the Plan). A key component of the Plan included the claw back of about 20 per cent of the Crown harvesting tenures. The Plan was enacted in response to the ongoing U.S. Softwood Lumber issue, and in part, in order to create opportunity for First Nations to participate in the forest industry. A significant portion of the clawed-back harvesting rights were to be distributed to First Nations as part of a larger package of measures aimed at eventual treaty settlement. With respect to the more important Softwood Lumber Agreement (SLA), a portion of the clawed back harvesting rights were to be redistributed to the BC Timber Sales program thereby creating an acceptable mechanism for determining market based stumpage rates for all remaining harvest tenures. It was felt that this action would create an acceptable market-based solution to timber pricing that would allow the BC government to then advocate for exemption from the SLA.

In both circumstances, it is clear that the Plan was introduced to further the government's public policy agenda related to the forest industry and land claims settlements within in BC and to provide a good that would be beneficial to Canadians as a whole. As part of the Plan, and accompanying legislation used to support it (Bill 28), the Provincial Government created the BC Forest Revitalization Trust (BCFRT). The fund was established to effectively mitigate losses suffered by contractors for the elimination of replaceable logging and road building contracts tied to clawed-back tenures and their employee severance.

The intent of the fund was to make contractors "whole" from the loss of their contracts, so they could invest in other businesses, acquire other contractors for right sizing and /or replace what was expropriated in monetary terms. In addition, in this example, contractors did not want to give up their contractual rights: in effect, there was no willing seller or buyer, and therefore, not a fair market value sale of contractual rights or services. Further, the Province employed the "trust" mechanism structure as the intention was for the funds to be considered non-taxable.

### **Canada Revenue Agency (CRA)**

In the above example, at the time the Trust was settled, it was perceived by the politicians, the trustee and contractors that individual businesses would be impacted by taxation differently, but it was felt the funds should and would be non-taxable. The use of a personal trust, as defined under the *Income Tax Act* was employed in distributing the funds. In fact, the Act deems that capital distributions from a trust (i.e. the funds put in the trust by Government) are non-taxable. It is anticipated that a similar funding / payment structure would be utilized in future compensation agreements set up by governments. The payments are made, not in exchange for a right, but for compensation as a result of enactment of public policy.

However, when the CRA began auditing contractors that received funds from the BCFRT, CRA's position and tax interpretations was to treat the receipts from the BCFRT as income for the contractors for tax purposes. The CRA asserted that the funds received are income since contractors suffered a lost opportunity, were provided an inducement and/or received proceeds of disposition re: timber resource property.

The CRA's interpretation of the *Income Tax Act* in these cases was inconsistent with what the provincial government intended. It was also inconsistent with the treatment of similar funds received for expropriations, which are taxed as capital gains. Further uncertainty has arisen because in some cases (*Frank Beban Logging Ltd. v. The Queen* and *Cranswick v. The Queen*) compensation received was held to be nontaxable. In addition, the historical tax treatment of fishery licence buybacks was to tax the proceeds to fishermen as a capital gain.

It has become unclear whether funds received in these circumstances are non-taxable, to be taxed as a capital gain or to be considered income for tax purposes.

### **Other Examples**

- Toronto Refiners & Smelters operated as a secondary lead smelter in downtown Toronto. When its property was expropriated by the City of Toronto, the company was not able to relocate. It ceased carrying on business and disposed of all its business assets to the expropriating authority. The City paid a total of \$12 million in compensation to company (\$2.0 million for the land, \$100,000 for the building and \$9 million because the business could not relocate). Toronto Refiners & Smelters treated the \$9 million as damages, a non-taxable receipt. However, upon reassessing the situation, the Minister of Revenue determined that the \$9 million was a sale of goodwill -- not compensation for damages -- and, therefore, eligible capital property. The company appealed. The Federal Court of Appeal opposed the Minister's evaluation and decided in favour of Toronto Refiners & Smelters. The \$9 million was treated as damages and, therefore, non-taxable
- Club Sani Sport de Brossard operated a sport centre in Quebec. The company intended to use part of its land to build a tennis court. Hydro Quebec expropriated part of that land and settled for a payment of \$350,000 (which included \$286,000 for permanent business losses). The Court ruled compensation paid on the expropriation was a whole amount that could not be split into various damage headings. As a result, it was considered a unitary sum and the full amount was treated as capital and, therefore, taxable as a capital gain
- In *Farrell v Minister of National Revenue*, Farrell owned land from which he removed gravel for sale. Ontario Hydro expropriated the land and compensated the owner for "granular deposits" based on the revenue Farrell anticipated from the sale of gravel. The Court ruled that compensation received for the business loss was to be treated as a capital gain.

### **Future Possibilities**

It is highly probable that these types of arrangements will be used in the future to compensate businesses impacted by further Government expropriations to settle land claims, reduce fishing rights/tenures, advance resort development opportunities and/or to create additional park land or protected areas.

However, in order for businesses and communities to take advantage of these compensation agreements or special funding mechanisms, the tax consequences of doing so needs to be clear and defined so as to avoid uncertainty and the lengthy and costly process of determining the application of taxation to receipt of funds from these agreements.

According to the BCFRT as of March 31, 2011, the BCFRT issue appeared near resolution with an oral agreement between the province and federal government that BCFRT will refund income taxes paid by contractors on amounts received under the BCFRT, and such payments will not be taxable. Final resolution was deferred due to the federal election, but with the election completed, the federal government is now in a position to resolve this matter (source: BC Forestry Revitalization Trust. Report of the Trustee as of March 31, 2011. p.3)

However, it is equally important that the federal and provincial governments bring certainty, and a fair and reasonable approach, to this issue more broadly, including all resource sectors, the affected Crown tenure holders and their affected contractors and employees.

### **Recommendations**

That the federal government publish appropriate Interpretation Bulletins to provide certainty in respect of similar expropriation compensation if the *Income Tax Act* already provides for clear, fair and reasonable treatment of this compensation, consistent with the apparent agreement in the BCFRT issue.