Woodland Income Tax And Estate Planning

Nova Scotia Department of Natural Resources

Home Study

Module 10B

JANUARY 2016 MANUAL HSC 2016-01

NOVA SCOTIA

Woodland Income Tax And Estate Planning

Nova Scotia Department of Natural Resources

Home Study Module 10B

JANUARY 2016

MANUAL HSC 2016-01

Prepared for:

Nova Scotia Department of Natural Resources
P.O. Box 698, Halifax, Nova Scotia, B3J 2T9

Updated by:

McIsaac Darragh Chartered Accountants, Amherst, Nova Scotia
Revised August 2015

Photos curtesy of Simon Mutabazi, and David Sutherland unless otherwise noted.

DISCLAIMER: The material in this guide is for educational purposes only. As many of the topics are complex, you are advised to consult with professionals regarding your own situation. All tax and other information herein is subject to change.

Forest Industry Sector – Overview

The forest industry is important to Nova scotia's economy. It is a large contributor to the Province's GDP – generating substantial export shipments ($700 million in good years) as well as employing over 5,000 individuals directly. The majority of forest product exports go to the US but also to Asia, with pulp and paper making the largest contribution.

In Nova Scotia, approximately 60% of the forest land base is privately owned. Consequently, the majority of the fiber used by the forest industry sector comes from private land.

As the need for sustainably managed wood grows, private forest land owners will continue to play an important role in the Province's economy.

Table of Contents

Part One: Woodland Income and Tax

Chapter #1: Business Types and Business Structures

Chapter #2: How is Your Woodland Income Taxed?

Chapter #3: Record Keeping and Measuring Income

Record Keeping Requirements

Measuring Income

Chapter #4: Miscellaneous Matters

WOODLAND INCOME TAX
AND ESTATE **PLANNING**

Part 1
Woodland Income And Tax

PART 1 • CHAPTER 1

Business Types and Business Structures

Nature Of Business

Meaning of "Woodland"

The purpose of this guide is to outline and discuss the main income tax rules and business issues that apply to woodland operations in Nova Scotia. It is not intended to be a comprehensive tax guide. Other taxes (e.g. property, deed transfer, etc.) are outside the scope of this guide and will not be dealt with. A glossary of terms is provided at the end of the module.

In this guide, the word "woodland" is used in a broad sense to mean a treed area of land. A woodland includes treed land held primarily as a source of fuel, posts, logs or trees, whether the trees are grown with or without human intervention. The term also includes treed land that is part of a cottage property and a farmer's wooded land.

Income tax rules and tax planning opportunities with respect to woodlands are complex. Of necessity, this guide will discuss issues from a broad perspective only. It will not attempt to investigate all the traps and pitfalls of the increasingly technical legislation. In the application of the following discussion to a particular situation, competent professional assistance is highly recommended.

Commercial vs. Non-Commercial Woodland

Where a taxpayer acquires a woodland with the intention to sell the wood and operates a woodland as a business with a reasonable expectation of profit, it is called a **commercial woodland**. A woodland that is not operated by a taxpayer as a commercial woodland is referred to as a **non-commercial woodland**.

The distinction between **commercial** and **non-commercial** is extremely important, as it is used to determine how your revenue is taxed by Canada Revenue Agency ("CRA"), which will be discussed in more detail under Business Income and Capital Gains. See Appendix 1 on page 71 for a decision tree on nature of business and income.

Reasonable expectation of profit

You can only determine whether or not you, as a woodland owner, reasonably expect to profit from the woodland by looking at the facts. You should ask yourself the following questions:

- Do I have a forestry management plan? Is it comprehensive? Am I implementing it?
- How much time do I spend on the woodland operation compared to time spent on other income earning activities?
- How big is the woodland? (It may be too small to give a reasonable expectation of profit).
- Do I qualify for some type of government assistance?
- What annual revenue, profits, or losses has the woodland made in the past?
- What are my farming or forestry qualifications (education and experience)?
- Do I belong to an association of woodland owners or other relevant professional business organizations?

No single factor will determine if your woodland has a reasonable expectation of profit. Some factors may be more important than others, depending on the circumstances. For a woodland operation to have a “reasonable expectation of profit”, a taxpayer should be able to show that with experience, time spent on training, skills, plans and financing, the operation will be profitable over the long run. It is not sufficient to purchase or own a property and hope that it will yield a profit.

Where a taxpayer owns a piece of land in conjunction with his or her home and sells some occasional surplus firewood, this does not qualify as the operation of a business.

Mixed-use woodlands

A mixed-use woodland is one where part of the property is personal (non-commercial) and part is business (commercial). If the woodlot is used primarily (CRA rule of thumb is > 50%) for personal use, it is considered a **non-commercial woodland**, and, if greater than 50% is business, then it is considered a **commercial woodland**. This is done on a deed-by-deed basis therefore, if the property consists of several separate deeds, each one is considered independently.

Is my woodland a farm business?

As you will see in a later Chapter of this module, whether or not a woodland is classified as a farm business will impact the way that you account for your activities as well as having certain tax benefits.

The Income Tax Act defines farming as:

"tillage of the soil, livestock raising or exhibiting, maintaining of horses for racing, raising of poultry, fur farming, dairy farming, fruit growing and the keeping of bees, but does not include an office or employment under a person engaged in the business of farming"[1]

Note that this list is not exhaustive and it has been determined by the courts that farming can include growing trees. The Canada Revenue Agency takes this view: if the main focus of the woodland business is not lumbering or logging, but is planting, nurturing and harvesting trees under a forestry management or other similar resource plan, and significant attention is paid to managing the growth, health, quality and composition of the stands, it is generally considered a farming business (a commercial farm woodland). Under these circumstances, reforesting an area of land to produce mature trees at a date that may be 40 to 50 years in the future would be considered farming.

If the main focus of a business is logging (a commercial non-farm woodland), rather than growing, nurturing and harvesting trees, carrying out reforestation activities would not transform that business into a farming operation. In addition, leasing or renting land for someone else to farm is considered rental income, not farming income.

Where a "traditional" farmer is also a woodland owner, the CRA generally considers income from the woodland to be income from farming.

Christmas Trees

A woodland owner who grows evergreens to sell as Christmas trees is regarded as being in the farming business regardless of whether he/she is carrying on any other type of farming operation - provided the operations are carried on with a reasonable expectation of profit.[2]

Maple

The extraction and collection of maple sap is considered to be a farming activity. The process of transforming the maple sap into maple products is also considered a farming activity so long as it is incidental to the extraction and collecting activities. Therefore, if you do not own a sugar bush, but purchase the maple sap, it is not considered a farming activity.[3]

Harvesting

There is a class of woodland owners who purchase cutting rights or forested land for the purpose of harvesting and marketing the wood product. CRA considers these taxpayers to be carrying on a logging business rather than farming. While this appears generally to be the case if purchases are of mature forests only, it does seem debatable where immature woodland is being cultivated to maturity. Where a taxpayer relies on naturally seeded regeneration, whether or not the business is a farming business depends upon the focus of the business and how the trees are nurtured.

Exercise 1

Jennifer has a management plan for her 115 acre woodland. Since she does not live near her woodland she hires a qualified contractor to manage it for her. The contractor looks after all the operations including harvesting, planting, thinning etc. according to the management plan and there is a reasonable expectation of profit. Does Jennifer's woodland qualify as a commercial farm business?

(SEE PAGE 78 FOR ANSWER)

If Commercial – Business Structures

The three most common types of business structures (also called 'business entities') are proprietorships, partnerships, and corporations. Each of these has unique legal and income tax features.

Proprietorship

A proprietorship is a business carried on by an individual. The individual is the owner, in charge of and ultimately responsible for all activities of the business. The owner assumes all the risks and does not share the profits or losses. Profits are calculated after deducting reasonable expenses. There is no legal difference between the individual and the proprietorship. If the business fails, the individual's personal assets may be subject to seizure by creditors.

For income tax purposes, the business income and losses are added to the individual's income from other sources. The proprietor is taxed on the net income, not based on cash drawings from the bank account. Tax is calculated on taxable income at graduated personal income tax rates.

Lumping together income and losses from different sources allows the individual to deduct losses against other forms of income, such as employment or investment income. This may be advantageous during a business start-up period when there are often losses.

Partnership

A partnership is an agreement between two or more parties to combine resources, credit, and expertise to carry on business together in order to earn a profit. Although the partnership possesses assets and property of its own, it is not a separate legal entity from the partners. Each partner is fully responsible for the debts and business obligations of the partnership, including contracts another partner enters into on behalf of the partnership. If the business fails, each partner's personal assets may be subject to seizure. Although a written contract is not necessary, a signed partnership agreement is highly recommended. This agreement should set out the rights and obligations of the individual partners, including but not limited to:

- income sharing entitlements
- financing or capital requirements
- property to be contributed
- personal involvement requirements
- requirements for contracting
- mechanism for dispute resolution
- admission and departure of partners
- dissolution of partnership
- death or disability of a partner

A partner who contributes a particular asset to a partnership would not necessarily receive the asset back if the partnership is dissolved unless it is written into the partnership agreement or otherwise agreed to by the partners.

For income tax purposes, the partnership calculates its taxable income and allocates this amount among the partners based on their agreed income sharing arrangement. A partnership does not file its own income tax return unless there is more than $5 million in assets, in which case a T5013 Partnership return is filed. The T5013 is an information return only. Each partner includes his share of income or loss on his personal income tax return. (Again, the amount of cash drawn from the partnership's bank account by a partner does not factor into the partner's income.) The result is the same as if each partner were a proprietor who had earned that much income or suffered that much loss.

An interest in a partnership is a **capital property** that can be sold or transferred to another person, subject to terms or conditions in a partnership agreement. Any gain or loss on the sale of a partnership interest would be a **capital gain** or **loss**. The cost base of a partnership interest is increased by the partner's share of earnings and reduced by the partner's share of withdrawals or distributions from the partnership.

On wind-up, a partnership generally disposes of all of its assets to its partners at **fair market value** (the amount an unrelated third party would pay for the asset). However, a rollover is available on the wind-up of a partnership where each partner receives a pro-rata undivided interest in each property of the partnership. The benefit of this rollover provision is that inherent gains in the partnership property are not taxed until sometime in the future. The drawback is that the partners must hold the property (distributed on wind-up) jointly. If this is impractical for some assets, they may be distributed to particular partners before the wind-up. A similar type of rollover is available where one partner buys out the other partners and carries on the business as a proprietorship.

Corporation

A corporation is a separate legal entity, distinct from its shareholders. It may own assets and incur debts and can generally contract and negotiate on its own behalf. Shareholders are not responsible for the debts of the company unless they have provided personal guarantees. Private companies are usually set up under the laws of a province, although federal incorporation is available. The incorporating statute will impose some formalities on the company, such as the need to hold meetings, elect directors and officers, and so on.

A corporate structure provides the greatest flexibility because family members such as a spouse or child over 18 years old that are in a lower personal tax bracket can own separate classes of shares to provide income splitting opportunities through the payment of dividends. In addition to the limitation of liability, a distinct advantage of incorporation is that shareholders may sell their shares in the business to another party and exit the business without interrupting the business' activities.

In practice, it is easier for a corporate taxpayer to carry on a reforestation, cultivating, and harvesting operation as a farming business. The indefinite life of a corporation lends itself to the long business cycle of a tree farming operation.

In cases where there is more than one shareholder, the shareholders should have a shareholders agreement that would guide the actions of shareholders when something goes wrong, such as a falling out between partners, the death or incapacity of a shareholder, buy/sell issues, etc. These issues are well beyond the scope of this course, but these cautions are meant to

reinforce the need to consult with a tax professional when incorporating a company to avoid potential issues in future and to set up a share structure that provides flexibility and future tax planning opportunities.

For tax purposes, a corporation calculates its own taxable income and files its own tax return. You can see from Appendix 3, a company in Nova Scotia pays tax at a favourable provincial and federal rate on its first $350,000 of business income earned in a particular **fiscal year**. If the business is profitable and generates more income than the shareholders need to withdraw for personal use, the difference of 36% between the tax calculated at the small business corporate tax rate and the highest personal rate is deferred until the retained earnings of the company are eventually distributed to the shareholders. The tax deferral provides additional funds within the company to finance growth or reduce debt. This deferred tax bill may be postponed indefinitely, as long as the profits stay in the corporation.

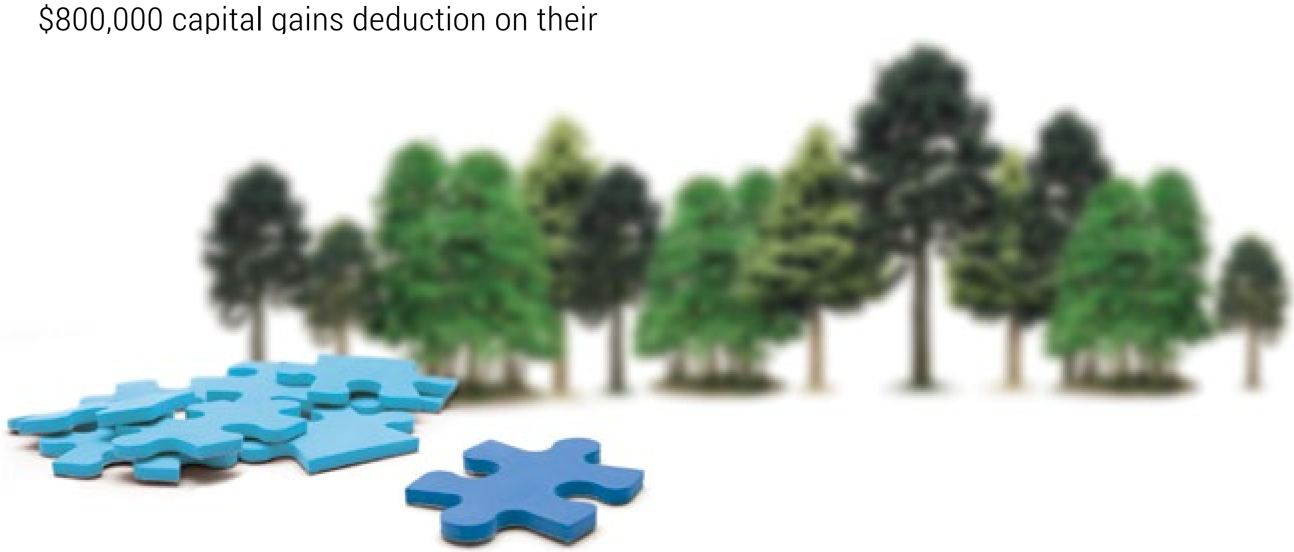
The gain on the sale of shares of certain qualifying corporations is eligible for an $800,000 capital gains deduction on their **disposition** (as discussed in Part 3: Estate Planning).

One disadvantage of incorporation is that if there are losses in the early years of a business, there is often no other source of income in the company against which they can be claimed. However they can be carried forward and claimed against future taxable income (Appendix 2).

On the wind-up of the business and distribution of the assets to the individual shareholders, the company is taxed based on dispositions of assets at market value. Shareholders will also be taxed on the amount of taxable dividends they are considered to receive. This ends the tax deferral advantage of incorporation we mentioned earlier, which is why a corporation often carries on as personal holding or investment company after the business activities have been wound down.

Choosing the right business structure

Choosing the right business structure will always depend on the particular circumstances of the business. Limited



legal liability, flexibility, and lower income tax rates available through a corporation are often deciding factors, but these are offset somewhat by higher cost of administration and complexity.

Changing from one business structure to another

You can start a business operation as a proprietorship and transfer the business assets to a partnership or a corporation at a later time without immediate tax consequences as long as the appropriate elections and tax filings are made, and the appropriate legal documents are signed. Similarly, you can incorporate a partnership without tax consequence or, as mentioned before; one partner can usually acquire the other partners' interests in the partnership and carry on the business as a proprietor without tax consequence to the continuing partner.

There are no provisions in the Income Tax Act however, for the transfer of business assets of a company out to individual shareholders so that the business can be carried on as a proprietorship or partnership. Such a transfer can rarely be made without tax. However, transfers of business assets between companies can often be achieved without immediate income tax effect.

Although switching between business structures is often feasible, it is certainly a complex area from an income tax point of view. There are many technical traps to avoid and many planning opportunities that should be considered, such as estate planning, income splitting, creditor protection, and so on. Remember that the purpose of "switching" is to achieve long-term advantages. Up-front costs should be evaluated like any investment undertaken by the business. Professional assistance is a must.

Quiz: Part 1 • Chapter 1

Based on your study of this section, please choose the best answer.

1 An individual who sets up a proprietorship is placing his/her personal assets at risk. ☐ True ☐ False

2 Under a proprietorship, business income and losses are lumped together with personal income. ☐ True ☐ False

3 Under a partnership, a member's personal assets are at risk if the partnership undergoes business failure. ☐ True ☐ False

4 Under a partnership with assets of $3 million, a separate T5013 Partnership Information return must be filed. ☐ True ☐ False

5 A corporation must file its own income tax return. ☐ True ☐ False

6 Proprietorships and partnerships will always qualify for the $800,000 capital gains deduction. ☐ True ☐ False

7 If you were to change your proprietorship to a corporation, there would be immediate tax consequences if certain provisions of the Income Tax Act are not followed. ☐ True ☐ False

8 The manner in which a taxpayer operates a woodlot may determine the amount of tax owing. ☐ True ☐ False

9 The only factor that determines if there is a reasonable expectation of profit is if revenue exceeds expenses for the year. ☐ True ☐ False

10 Where a woodland owner can clearly show that he/she expects to profit from operations on the woodland, the woodland is referred to as a non-commercial woodland. ☐ True ☐ False

11 A woodland owner who grows Christmas trees is in the farming business. ☐ True ☐ False

12 If you have a woodland that is used 60% personally, it is considered a non-commercial woodland by CRA. ☐ True ☐ False

(ANSWERS ON PAGE 78)

PART 1 • CHAPTER 2

How is Your Woodland Income Taxed?

INCOME TYPES

Capital Gains (Non-Commercial Woodland)

On a non-commercial woodland, where harvesting wood is not part of the taxpayer's principal business activities, the proceeds received from the sale of timber or the rights to cut timber are generally treated as proceeds of a **capital gain** if all of the following conditions are met:

- the land was not acquired with the specific intent of selling timber or land;
- it is an isolated sale of capital property by the person (and not the sale of a continuing right to enter and take away timber);
- the total price for the timber sold is fixed; for example, the contract for sale of timber specifies the consideration computed by reference to the timber actually removed within a specified time or from a specified area; and
- the timber is to be removed over a short period of time (such as several months)[4]

A capital gain will also result from a **disposition** of the woodland, which includes a sale, a gift or any other transaction where the "**beneficial ownership**" of the property changes. The concept of beneficial ownership is discussed later in this chapter.

There are also a number of situations where the Income Tax Act deems that a disposition has taken place. That is, there are times when it is assumed, or deemed, you have disposed of your property. For estate planning purposes, the most important of these is that you are deemed to have disposed of all of your property when you die (this will be discussed further in Part 3).

Exchanges of property will produce **proceeds of disposition**. If you exchange properties with another person you will have proceeds of disposition equal to the **fair market value** of the property

you receive. That is, if you exchange your woodland for your friend's house, which is worth $80,000, you will have **proceeds of disposition** of $80,000.

Taxation of Capital Gains

A **capital gain** is calculated by deducting the **adjusted cost base** of the asset from the proceeds of disposition less any disposal costs (such as legal fees or survey costs). The **adjusted cost base** is generally the amount you pay for an asset, including legal fees, survey fees or other costs to obtain title of the property. Specifically for woodlands, if only a portion of the woodland is cut, the adjusted cost base relating to the sale is reduced by the value of bare land and then calculated as the percentage of wood cut over the total wood volume multiplied by the total cost. For example, let's say a 50 acre woodland was purchased in 1990 for $25,000 and the value of the bare land was $5,000. If only 10 acres were cut the adjusted cost base of the wood sold from the 10 acres would be calculated as follows:

10 acres / 50 acres x ($25,000 - $5,000)
= 0.2 x $20,000
= $4,000

This calculation assumes each acre had roughly the same cruise value on purchase. The calculation is often based on wood volume rather than acreage, which is more accurate if a cruise has been documented.

The portion of the capital gain that is taxable depends on the date that the sale is made. Since October 17, 2000, only half (50 per cent) of the capital gain is included in taxable income. This **taxable capital gain** is included with your other income and taxed at your **marginal tax rate**. There is no specific "Capital Gains Tax."

If instead of purchasing the woodland, you inherited it; your cost base is equal to the fair market value of the property at the time of the inheritance.

If you owned the property prior to December 31, 1971, referred to as **Valuation Day** or V-Day, you can elect (choose) to use the V-Day value as your cost base – that is, the value from December 31, 1971. An alternate method uses the **median rule.** Using this method you find the adjusted cost base by working out which of these three amounts – the cost, the proceeds of disposition, or the fair market value on Valuation Day – has a value that falls in between the other two – this is the median. Usually this will work out to be the V-Day value.

If the adjusted cost base plus the costs of **disposition** exceed the proceeds of disposition, then there is a **capital loss**. The allowable **capital loss** is one-half of the loss. Gains and losses are netted - or offset - against each other for the year. If there is a net loss, it can be carried back three years and forward indefinitely. A capital loss can only be deducted against capital gains.

Your principal residence is a special type of **capital property**. It includes your house (or cottage/other dwelling – you can choose) plus one acre, unless you can demonstrate that more land is required for the use and enjoyment of the property. An example of a need for more land would be a zoning by-law that requires a minimum lot size.

A gain on the disposition of your principal residence is not taxable. This is true even for any gain that might result from a deemed disposition on death.

If your principal residence is on a piece of land with a woodland, you are required to prorate your **adjusted cost base** between the woodland and the one acre allowed for enjoyment.

Here are two examples of how the capital gains rules work.

Example 1

Assume that you purchased a woodland in 1965 for $3,000. At December 31, 1971, it was worth $5,000. In 2008 you sold it for $75,000 and paid a real estate commission of $4,000 on the sale.

Your **proceeds of disposition** would be the sale price of $75,000.

There are two ways to arrive at your **adjusted cost base.**

By the **median rule** method, the **adjusted cost base** would be the median (middle) amount of the cost of $3,000, the V-Day value of $5,000, and the **proceeds of disposition** of $75,000 (in this case it is the V-Day value of $5,000).

By the V-Day value method the **adjusted cost base** would simply be the V-Day value of $5,000.

In our example, the two methods produce the same result; an **adjusted cost base** of $5,000 and a gain of $70,000. From the above result, we subtract our cost of **disposition**, the commission of $4,000. This leaves us with a **capital gain** of $66,000. The **taxable capital gain** included in your income is 50% of this or $33,000.

Example 2

Assume a commercial non-farming woodland was purchased in 1980 for $10,000 and today is worth $80,000. You decide to give the woodlot to one of your children.

Your **proceeds of disposition** will be the **fair market value** of $80,000.

Your **adjusted cost base** is the original purchase price of $10,000.

As there are no costs of **disposition** on the transaction, your **capital gain** is $70,000.

And your **taxable capital gain** is 50% of that or $35,000. If your tax rate were 35%, then your tax obligation would be $12,250.

Exercise 2

Denis purchased a woodland for $25,000. It was determined that the bare land value was $10,000. Denis later decided to harvest all of the wood and received proceeds of $60,000 for the wood (he kept the land). Professional fees on the sale of the wood were $1,700. Calculate the capital gain and the taxable capital gain.

(SEE PAGE 78 FOR ANSWERS)

Dealing at Arm's Length

The Income Tax Act refers many times to dealing at **arm's length**. People deal at **arm's length** when they have separate and opposing economic interests. The Income Tax Act deems (assumes) that related persons do not deal at **arm's length**. Related persons are your parents, children, spouse, in-laws and any corporation that you or they control. Unrelated persons may not be dealing at **arm's length**, but this is dependent on the facts of the situation.

The importance of the concept of **arm's length** is that transactions between persons not dealing at **arm's length** are deemed to take place at **fair market value** rather than the notional transaction price. The effect of this is that if you gift your $80,000 woodland to your children, you will be deemed to have disposed of it for its **fair market value** of $80,000 and your children's costs base will also be $80,000. If you sell a woodland with a fair market value of $80,000 to your children for proceeds of $30,000, your deemed proceeds on sale for tax purposes will be $80,000, but your children's cost base will only be $30,000. This will result in a form of double taxation in the future when the children sell the property. The solution may be to sell a % interest in the property and gift the rest to preserve the cost base.

Business Income (Commercial Woodland/ Commercial Farm Woodland)

If the woodland owner has a **commercial woodland** where they actively cut and sell the wood product with a reasonable expectation of profit, it seems clear that they are in business, and revenues received are included in computing business profits. The same applies to a commercial farm woodland, whether a Christmas tree farmer, other tree farm focused on growing and nurturing the trees, or a maple product producer, all revenues are included in computing business profits. The following are two other scenarios where income that would otherwise be a **capital gain**, could be determined to be business income by CRA:

- **"Adventure in the nature of trade"** – if the woodland owner's actions are essentially what would be expected of an individual operating the same type of business as a commercial woodland. This activity may be a one-time adventure, but if the owner enters the transaction with a reasonable expectation of profit, and acts otherwise as a commercial woodland operator would do, then the income is considered to be earned from an adventure in the nature of trade and is taxed as business income
- **Payments based on production or use** – where the woodland owner allows a person to cut and take timber and the

payment is based on the volume of timber taken, instead of a fixed price per hectare for example, then the payment is taxed as business income. Note that case law has consistently excluded from "payments based on production or use" rules a one-time contract for the removal of timber.[5] **Proceeds** will therefore be taxed as a **capital gain**, not business income.

Taxation of Business Income

As we saw above, **capital gains** are given preferential tax treatment since only 50% of the gain is included in income.

In contrast, business income or farming income is fully included in the calculation of taxable income. Business income is calculated by deducting business expenses from revenue. The typical revenues and expenses that are used to calculate net business income will be discussed in Chapter 3.

Business Losses

When computing your business income, you are only allowed to deduct expenses that were incurred for the purpose of gaining or producing income from the business. This provision of the Income Tax Act operates nicely when profits are being earned, but leads to uncertainty when losses are incurred.

If losses continue for several years it becomes more and more important that you can demonstrate a "reasonable expectation of profit" (supported by financial projections and other evidence), as the CRA is more likely to challenge you with each year that passes. If you cannot demonstrate a "reasonable expectation of profit," the expenses/losses (net of revenues) are considered to be personal in nature and cannot be deducted against other sources of income.

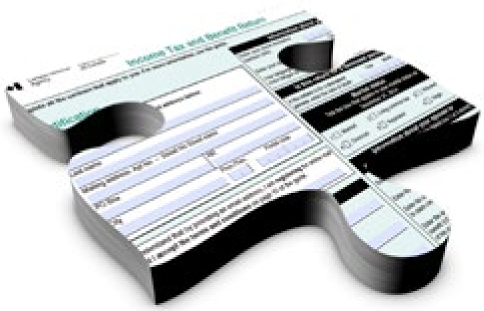
If business losses exceed income from all other sources in a particular year, the excess loss may be carried back 3 years to recover tax previously paid or carried forward 20 to reduce future taxable income. See Appendix 2 for details on the allowable carry-over period.

You should note that use of the word loss or losses refers to the situation where deductible expenses exceed revenues. It does not necessarily include the situation where a woodland owner suffers an economic loss due to a natural event such as fire, hurricane or insect damage. Under these circumstances, the taxpayer might be entitled to a write-off only if there are previously un-deducted costs associated with the woodland. Such a write-off would not be available for any costs attributed to the underlying land.

Reporting

When is income reported?

For a commercial woodland, CRA requires the income to be reported when earned. This is the year in which the wood is cut and shipped, which is not necessarily when the cash is actually received (unless farming and you choose the cash basis – see Basis of Accounting on page 19). For a non-commercial woodland, income is included in taxable income based on the date of the sale agreement. If part of the proceeds is not due until a subsequent year, the **capital gain** in respect of the portion of the proceeds not received can be deferred until the taxation year in which they are due. A minimum of 20% of the gain must be included in income each year; therefore, it is possible to spread the inclusion of the **capital gain** over a maximum of five years. Note that taxpayers generally will try to spread the sale over two years, as most do not want to wait five years for the full proceeds.



Who reports the income?

For tax purposes, the business income or **capital gain** must be included in the income of the **beneficial owner** of the standing timber, which is the person who enjoys the possession and benefits of the property. A property might be in the name of two or more persons but this does not necessarily mean that all individuals have **beneficial ownership**. In fact, there are three possible types of joint ownership for assets that have two or more names listed on the deed.

We will follow through the three types using the example of a mother adding her son to the deed of a woodland. The first option is a 'true joint tenancy'. In this case, the mother and son have a joint legal interest and a joint beneficial interest and are registered on title as joint tenants. The mother will no longer have full control as they have identical rights to the assets and any income it derives. When the mother adds her son to the deed, she is deemed to have disposed of ½ of her interest in the property and this may result in a tax liability.

The second type is a 'resulting trust joint tenancy' where the mother and son have a joint legal interest in the woodland but the mother retains full **beneficial ownership**. Under this scenario, the son essentially acts as a trustee, with no right to the benefits of the property. In this case, adding her son to the deed will not result in a deemed disposition for the mother. The beneficial ownership on death of the mother is transferred to a trust, where the property will be distributed as per the Will.

The final type is a 'joint tenancy with right of survivorship'. This is similar to the above option such that there is joint legal interest, but no change in the **beneficial ownership**. The difference is that when the mother passes away, **beneficial ownership** automatically transfers to the son, i.e. the **beneficial ownership** is 'gifted' to him. Again, adding her son to the deed in this manner will not result in a deemed **disposition** for the mother.

It is important that in making these decisions you document your intent, and your Will should be written in a consistent manner for dealing with the property.

The rest of Part One of this guide will be devoted mainly to those taxpayers who own and operate a woodland as part of their on-going business activities (**commercial woodland**).

Quiz: Part 1 • Chapter 2

Based on your study of this lesson, please choose the best answer.

1 Income from the sale of timber from a commercial woodland will always be treated as a capital gain. ☐ **True** ☐ **False**

2 If you inherit a woodland and make no attempt to operate it as a business, income received from timber sales is treated as a capital gain. ☐ **True** ☐ **False**

3 If there are two names on the deed of a woodland, both of these individuals are the beneficial owners, and therefore automatically share the income from a harvest equally. ☐ **True** ☐ **False**

4 Income from a commercial woodland is to be reported when the wood is cut and shipped. ☐ **True** ☐ **False**

5 Natalie purchased a woodland in 2001 for $30,000. No harvesting has occurred since the purchase. In 2013 she sold the woodland for $60,000 and there were legal fees of $3,000. What was the taxable capital gain?

_____ **A) $30,000** _____ **B) $17,000** _____ **C) $27,000** _____ **D) $13,500**

6 If Rachel sold her non-commercial woodland for $70,000 in 2005 and she was going to receive $10,000 each year for the next seven years, how many years could she spread the capital gain over for tax purposes?

_____ **A) one** _____ **B) two** _____ **C) five** _____ **D) seven**

7 Costs of disposition, including legal fees, are taken away from the proceeds when calculating **capital gains**. ☐ **True** ☐ **False**

8 If a proprietorship had a business loss in 2014, he/she could carry the loss:

_____ **A) back three years and forward seven**

_____ **B) back three years and forward twenty**

_____ **C) back seven years and forward indefinitely**

_____ **D) can't use the loss for another year**

(ANSWERS ON PAGE 78)

Record Keeping And Measuring Income

Record Keeping Requirements

Record keeping

Anyone carrying on a business is required by law to maintain books and records so that they can determine income and what taxes they must pay. They must also keep records documenting the calculation of payroll taxes, HST, workers' compensation, and so on. Keeping books and records generally centres on the bank account. As a rule, corporations and partnerships have a separate bank account through which the business transaction would flow. Although not legally necessary, record keeping for a proprietorship is much simpler if a separate bank account is kept for business transactions.

Record keeping systems are available to suit all levels of complexity. Generally they are designed to document and summarize revenue and expense transactions, and to keep a financial record of investments in assets and business liabilities.

A basic manual record-keeping journal is shown in Appendix 4. You enter financial details of business transactions in a multi-column journal, often called a cashbook, as the cash is received or disbursed. You keep separate account columns for each category of receipt or disbursement that is regular or large. This makes it easy to summarize accounts and prepare financial statements from time to time. Cashbooks are available with many columns and, if necessary, the receipt and disbursement transactions may be kept in separate journals.

A new cashbook should be used for each fiscal period. It should be totalled and balanced from time to time – preferably monthly. Regardless of the size of the business, it is important to compare and reconcile the transactions in the cashbook with those on the business bank statements.

As business activity grows a computerized system will be the practical solution. Computerized record keeping through an off-the-shelf package is most common and is not difficult to learn if you have basic computer skills.

The most common accounting software packages include Sage 50 (formerly Simply Accounting) and Quickbooks. They can range in price from $100 for the most basic package to over $500 for versions with all the extra features. There are other software packages available and advice should be sought from your accountant before making a choice to make sure the software will meet all your needs.

There are several advantages to using a computerized accounting system; the most important is that it makes the bookkeeping process more efficient and less prone to error.

In addition, preparing reports is less time consuming as there is no need to add up columns of numbers. Reports, such as a balance sheet and an income statement can be run as needed with varying date ranges, for example monthly or year to date. They can also show a comparison to the prior month, year or to a budget. This makes it much easier to see where your business stands at any time.

Although your accounting records document and summarize transactions, you must also keep the supporting documents themselves - contracts, expense invoices, revenue invoices, deposit slips, bank statements and cancelled cheques, etc.

Canada Revenue Agency requirements

CRA will allow the following methods of record keeping:

- Books, records, and supporting documentation prepared and kept in paper format.
- Books, records, and supporting documents prepared on paper and later changed to and stored in an electronically accessible and readable format, such as a PDF file.
- Electronic records and supporting documents prepared and kept in an electronically accessible and readable format.[6]

CRA does not specifically tell you what needs to be kept, but your records have to be reliable and complete, provide the appropriate information needed to determine your tax obligation, be backed up by original documents for verification of transactions, and include additional documents that help to determine tax obligations, such as appointment books, mileage logs, GST/HST returns, and so on.[7] In addition to this, if your business is incorporated CRA requires you to keep any minutes of meetings held, a record of the corporation that includes information relating to ownership of shares; general ledgers that summarize the transactions of each year; and special agreements needed to back up the entries in the general ledger if they are difficult to understand.[8]

Per CRA, the general rule is to keep all records and supporting documentation, whether in paper or electronic format, for a period of six years from the date CRA assesses your tax return. You should note that if you use computerized systems to generate records, you must keep the electronic records, even when a hard copy is kept. Documents dealing with items of a long-term nature that would affect eventual sale or wind-up of business should be kept indefinitely. Examples would be loan documents, equipment purchases, share registry etc.

Penalties may be imposed by CRA if adequate records are not kept, you do not give officials access to your books when requested, or you do not provide information to officials when asked. In addition expenses may be disallowed if you cannot provide supporting source documents. These fines can be large and therefore it is advisable to keep well-organized records.

Measuring Income

Basis of Accounting

There are two methods of accounting: **accrual** and **cash**. **Accrual accounting** is the method used by most non-farming businesses to prepare their income tax return. With **accrual accounting**, revenue and expenses are recorded when earned or incurred, not when cash is received or paid out. For example, a December phone bill is incurred in December, but not usually paid until January. If a lending institution, such as a bank, requires financial statements they will typically need to be prepared using the **accrual** method of accounting.

A special provision is available to farmers, which allows them the choice to report on the **cash basis** instead of the **accrual** basis for tax purposes.

If you use the **cash basis**, you only report for tax purposes revenues for which the cash has actually been received, and expenses actually paid in the year to determine income. This lets the taxpayer reduce income, for example, by paying off outstanding bills at year-end or by prepaying for expenses.

Cash basis farmers do have the option of adding an amount to their income up to the **fair market value** of their **inventory**. This allows them to smooth or average income. By using these provisions they can avoid the possibility of not paying any tax in one year, and missing the advantage of the low marginal rates, followed by a year of high taxable income, some of which is subject to the top marginal rates. The provision may also be used to increase income and take advantage of old losses that might otherwise expire. However, in years where the farmer has a loss, it is no longer an option, it is mandatory to increase the income to the lesser of the net loss, or the value of the purchased inventory still on hand at year end.

You can switch from the accrual method to cash method simply by filing an income tax return using the cash method. Once you choose to file your tax return using the **cash** basis, you can only switch to the **accrual basis** of accounting with the approval of CRA.

Receipts/Revenues

Businesses normally generate their cash flow from one or two main sources, so the variety of cash receipts that a business must account for may be small. It is often helpful when managing a business to have a more detailed breakdown of these revenue sources, but there is no requirement to do so. A woodland operator may want to track revenue from hardwood and softwood sales separately, for instance, or keep cedar and spruce sales separate, or track revenue from one woodland separately from another. If you need such a detailed breakdown, it can easily be handled with the record keeping system outlined above by adding the appropriate columns to the cashbook. Nevertheless, most cash receipts could be accounted for under the following headings:

- sales revenue/collection on account
- HST collected
- miscellaneous/sundry income
- loans received
- other receipts (e.g. equipment sales or trade-ins, advances from shareholders, HST refunds, income tax refunds, and so on)

Sales revenues, **sundry income** and equipment sales are all relevant in determining taxable income.

Government Grants

The general rule is that all government grants are included in income from a business.[9]

If the grant relates to the cost of acquiring **capital property** the grant reduces the cost of the property for **capital cost allowance** and investment tax credit purposes (discussed later in this section).[10]

If the grant was received to fund general operations, such as repairs and maintenance, it would either be fully included in income - with any expenses incurred fully deducted - or it would be offset against the expenses with the net expenses being deducted. These alternative methods produce identical results.

Expenses

Vehicles

Vehicle operating costs incurred for earning income can be deducted to determine your net income. Some of these costs include, lease payments, interest on loan to purchase a vehicle, repairs, insurance, fuel and so on.

The rules for the deductibility of vehicle expenses differ whether the business is operated as a proprietorship or a corporation and whether the corporation owns the car or the individual does.

In a proprietorship, if the vehicle is also being used for personal purposes, appropriate adjustments should be made to the expenses claimed by the owner. Total expenses would be prorated between business and personal use, based on a mileage log.

If vehicles used personally are owned by a corporation, taxable benefits will be assessed for personal use. On the other hand, if vehicles are personally owned and used in the corporation, the corporation can pay out a tax-free allowance on a reasonable per kilometre basis to reimburse you for business kilometres. The mileage allowance is deductible to the company and is deemed to include HST. The maximum allowance that can be paid and deducted by a corporation and is a non-taxable benefit to an employee in 2014 is $0.54/km for the first 5,000 km and $0.48/km thereafter. There are various restrictions on the expenses that can be claimed based on the type of vehicle and its business versus personal use. You should consult your accountant to discuss and advise you in this area.

Maintenance and operating costs

Annual maintenance costs such as thinning and spraying should be fully deductible as incurred or as paid, depending on which accounting method you use. Other costs such as labour, equipment operating and maintenance costs, property taxes, office supplies, land clearing, temporary access roads, and marketing expenses would also be deducted as incurred or as paid.

Interest and taxes

Interest and property taxes are deductible expenses provided they are incurred to earn income from a business or property. Although there may not be revenue in a given year, if a woodland is held mainly with the intent to produce income, then interest and property taxes should be deductible. Any interest or taxes paid to CRA are not deductible for income tax purposes. Amounts owing to CRA should be paid on time to prevent paying interest and penalties that cannot be deducted for income tax purposes.

Business use of home

Often a small business owner will operate a business out of their own home instead of renting office space. When portions of the home are used for the business only (such as office or storage space) then some home expenses can be deducted as a business expense. Examples of home expenses that can be deducted include power, heat, property taxes, repairs, insurance and mortgage interest. These expenses are limited to the portion of the home that is used for business. For example, if there is a dedicated home office that is equal to 10% of the total home's square footage, then 10% of the expenses can be deducted. Note that capital cost allowance (tax depreciation) should never be claimed on your primary residence as it could interfere with personal tax planning.

Payroll

Deductions

When a woodland owner has employees they are required to deduct premiums for Canada Pension Plan (CPP), Employment Insurance (EI) and Income Tax from their wages and remit them to Canada Revenue Agency (CRA). In order to do this, a payroll account will need to be opened with CRA. This can be opened under the name of either an individual or a corporation.

Deductions can be calculated by most accounting software packages or by using an online payroll calculator available on CRA's website. When hired, the employee will need to fill out two TD1 forms (one federal and one provincial) in order to determine the amount of income tax to deduct. These will need to be updated each year when the tax tables change on January 1st and sometimes July 1st.

In addition to the amounts deducted from the employee, the employer must also pay a portion of CPP and EI premiums. With CPP, the employer matches the amount paid by the employee. The employer portion of EI is 1.4 times what the employee pays. The employer does not pay any portion of the employee's income tax.

Typically, payroll remittances are paid monthly and are due on the 15th of the following month (for example, the January remittance would be due on February 15th). It is possible to pay remittances less often if the average monthly remittance is below $3,000 or more often if the average monthly remittance is over $15,000. These changes in remitting frequency are determined by CRA.

Significant penalties and interest can be charged by CRA for failure to deduct the correct amount and for filing late remittances. Therefore, it is important that once a payroll account is opened, deductions and remittances are calculated correctly and filed and paid on time. If there is going to be a period of time where there are no employees you can either file a nil remittance for each of those months or call CRA to temporarily close the account until you have employees again.

Often an employer may try to circumvent this process of calculating deductions and paying remittances by labelling the person they hired as a self-employed contract worker. A person or business must be cautious in doing this. CRA has very detailed rules about whether an individual is an employee or self – employed. Going through these rules is beyond the scope of this course. It is recommended that the CRA guide RC4110 is reviewed before hiring an individual as a contractor.

Reporting requirements

At the end of the calendar year T4's and a T4 summary need to be prepared and filed with CRA. Copies of the T4's are then given to the employees. This must be done by the last day of February of the following year. Failure to do so will result in a penalty equal to $10 per slip per day late with a minimum penalty of $100 and a maximum of $1,000. If there are over 51 T4 slips late, the penalty increases. (These rates are as of December 2014).

If a person was hired as a casual worker or as a self-employed person under contract, T4A's and a T4A summary are prepared instead. The same deadline applies.

When an employee leaves or is laid off, a Record of Employment (ROE) must be prepared and filed with Service Canada within 5 days of the last day worked by the employee. Filing this form is necessary in order for your employee to receive EI and other benefits. If CRA has to request the ROE, the fine for late filing can be up to $2,000 and/or jail time.

Workers' compensation

Workers' compensation premiums are used to provide no fault insurance and accident prevention services to employers and to provide benefits to injured workers. In Nova Scotia, this program is operated by the Workers' Compensation Board (WCB) of Nova Scotia.

If a woodland owner has more than 3 employees at any one time (including the owner), they must register and pay into WCB within 10 days of hiring the third employee.

After registering, the WCB will determine the premium rate based on the industry. A form will be provided monthly to calculate and remit premiums based on actual wages paid to employees during the month. The payment is due on the 15th of the following month. WCB coverage cannot be cancelled unless the woodland owner is certain there will be less any 3 employees for the next 12 months.

If a sub-contractor is hired, it is necessary to have them provide a clearance certificate from the Workers' Compensation Board of Nova Scotia as proof that they are registered and paying workers' compensation premiums. If the subcontractor is not paying workers' compensation premiums in NS, then the company hiring the sub-contractor is required to pay those premiums for the sub-contractor by including the sub-contractor's wages in what they report to WCB NS.

It should be noted that if the owner is receiving dividends instead of a salary, they are counted as an employee but are not covered by WCB. If the owner is being paid a salary or wage, they will be covered by WCB since this compensation is included in the calculation of WCB premiums.

The workers' compensation program is different in each province and premiums are paid based on the province worked in. If employees are working in a province other than NS, workers' compensation premiums may need to be paid in that province instead of NS. It is suggested that, if work is done in other provinces, inquiries be made into how workers' compensation is handled in that province.

Capital costs

Amortization/Depreciation

Payments on capital assets cannot immediately be deducted for income tax purposes. This is true regardless of whether the taxpayer calculates income using the **cash basis** or the **accrual basis** of accounting. Capital assets tend to be of a long-term nature and provide an enduring benefit. Examples include land, buildings, automotive and other equipment (such as motor vehicles, tractors, chainsaws, winching equipment, skidders, etc.), fencing, timberland, etc. Generally, equipment or tools that will be of use for more than one year are considered capital assets and are depreciated over the long term for income tax purposes.

For practical purposes, an immediate write-off is allowed for tools costing less than $500.[11] Note that an item that may appear by itself to be a capital item may be deductible as a repair if it is in fact a replacement part or component for a larger piece of machinery. **Inventory** (such as seedlings and plantations, see below) is not considered a **capital asset** and neither is the cost of supplies that are consumed in the course of business.

For income tax purposes, depreciable capital assets are grouped into classes. Capital cost allowance (depreciation) is then calculated at prescribed rates on a declining balance basis. Only one-half of the normal capital cost allowance rate is used on the net additions to a class for any particular year. Net additions are calculated as the cost of assets purchased less the proceeds from assets that were disposed of, up to the asset's original cost, for any assets of the same class during the year. The table on the next page shows the use of the capital cost allowance system.

Capital cost allowance is a discretionary deduction, which means a taxpayer is not required to deduct capital cost allowance in determining their taxable income for a particular year. In a year with a loss, it would be beneficial to not deduct capital cost allowance, leaving it available for future years when there is income.

Capital Cost Allowance System	Buildings Class 1: 4%	Office Equipment Class 8: 20%	Logging & Auto-motive Class 10: 30%	Logging Truck Class 16: 40%	Total
Undepreciated Capital Cost, Jan 1, 2014	75,250	5,988	78,542		159,780
2014 Changes					
Building expansion	19,500				19,500
Purchased new skidder			130,000		130,000
Trade in value of used skidder			(34,000)		(34,000)
Purchased new low truck				87,250	87,250
Subtotal	**94,750**	**5,988**	**174,542**	**87,250**	**362,530**
Maximum Capital Cost Allowance					
(75,250 x 4%) + (19,500 x 4% x 50%)	3,400				3,400
5,988 x 20%		1,198			1,198
(78,542 x 30%) + ((130,000 – 34,000) x 30% x 50%)			37,963		37,963
87,250 x 40% x 50%				17,450	17,450
Total Capital Cost Allowance Claim	**3,400**	**1,198**	**37,963**	**17,450**	**60,011**
Undepreciated Capital Cost Dec 31, 2014	**91,350**	**4,790**	**136,579**	**69,800**	**302,519**

You should note that if all assets in a class have been disposed of, any remaining balance may be written off. This is referred to as a terminal loss. On the other hand, if the proceeds from the disposal of assets result in a negative balance in the class, this amount gets included in income as recaptured depreciation.

Depletion

The Canada Revenue Agency refers to woodlots as "timber limits," in other words a treed area of land. The cost of a "timber limit" includes the cost of the underlying land and may also include the cost of surveys, cruises, maps, and so on. The total cost - less the residual value of the land and the cost of surveys, cruises, maps, etc. - is depleted when trees are harvested. A deduction for depletion, based on quantity harvested, is calculated by multiplying this "net cost" of the timber by the quantity of wood harvested and dividing by the quantity of timber in the limit as shown by a cruise. A further deduction – equal to one-tenth of the cost of surveys, cruises, maps and so on - is allowed until their cost has been fully deducted.

For example, let's assume a woodland owner is beginning to harvest a timber limit. The owner's cost of the timber limit is $55,000 of which $8,500 represents the residual value of the land. In addition, $5,000 has been incurred for cruises, surveys, etc. The cruise indicated that there were 2,500 cords of timber in the limit of which 625 were harvested during the year. In the example below we show how to calculate the deduction for depletion of the timber limit.

Basic deduction

= (Cords harvested / Cords documented by cruise) X (cost of timber limit less residual value of land)

= (625/2500) X ($55,000 - $8,500)

= $11,625

Additional deduction re: cost of cruises, surveys, etc.

= Total cost thereof X 1/10

= $5,000 x 0.1

= $500

Total depletion deduction for the year is $12,125 ($11,625 + $500).

There is an alternative method of claiming depletion for a timber limit in which the lesser of $100 and the amount received in the year for the sale of timber is allowed as a deduction. This method obviously has limited application and benefit, but may apply where the timber resources have not been documented by a cruise or where the property was inherited many years ago when it had little value.

Like **capital cost allowance**, depletion is also a discretionary deduction, and can be saved to deduct in a future year.

Exercise 3

In 2012, Ian purchased 150 acres of land for $45,000. The bare land value of the land is $15,000. Prior to purchasing, he had the woodland cruised, which indicated that the woodland contained 2,400 cords of wood. In 2013 he purchased a used ATV for $9,000 and a used wood splitter for $2,000. In the fall he cut and sold 18 cords of stud wood and 6 cords of firewood.

A) Assuming a capital cost allowance of 30% for the ATV and 20% for the wood splitter and that he bought the ATV for 75% business use and 25% personal use, what deduction can he make for his equipment purchases in 2013

B) How much can he claim for depletion of the land?

(SEE PAGE 78 FOR ANSWER)

Roads

Whether or not the costs of constructing a road are considered capital or a current expense depends on the type of road it is. Roads are considered capital if they are expected to have a useful life of more than 3 years or will be useful beyond the life of the woodland it is servicing. Spur roads or trail branching off from another road to access a specific area of the woodland where all the timber will be removed within 3 years would be an expense in the year the costs are incurred. Roads constructed on someone else's land are typically expensed.[12]

Inventory

The cost of seedlings and planting represent the cost of inventory for tree farmers, and, for cash basis taxpayers, these costs would be deductible as paid. The CRA's position appears to be that the cost of planted seedlings does not represent "purchased inventory" subject to the mandatory inventory adjustment. This means that even if there is a loss in the year, the cost of planted seedlings and related materials used do not need to be added back. Remember, however, that cash basis farmers can also smooth or average their income by adding to income an amount up to the fair market value of their inventory. For accrual basis taxpayers, these costs would be carried forward and deducted against future revenue. If the taxpayer operates woodlands but generally not as a farmer, the costs of seedlings and planting would become part of the cost of the timber limit.[13]

Farm Losses

A **commercial woodland** owner not operating as a farm is able to use the full amount of a business loss to carry back 3 years or forward 20 years as previously discussed. However for farming woodland owners, the amount of a loss that can be deducted for tax purposes depends on the type of farmer. Based on the 2013 Federal Budget, farmers can be categorized as follows:

1. Full-time farmers, with no other significant sources of income;
2. Farmers whose dominant source of income is farming, with a second source being subordinate to farming;
3. Farmers with other sources of income that are supplemented by farming; and
4. Hobby farmers who have no reasonable expectation of profit from their farming activities.

For the first two classes, losses can be used fully. Losses suffered by a farmer in class 3 are restricted. A hobby farmer does not claim income or losses on their tax return.

Unrestricted Farm Losses

For farmers with other sources of income, in order for the loss to be unrestricted (full loss can be deducted against other sources of income), they must be able to demonstrate that they put significant effort and capital into farming (more so than their other sources of income).

Restricted Farm Losses

Where a taxpayer's other sources of income are not subordinate to farming, farm losses are restricted. The loss from farming that can be used as a deduction against income from other sources is limited to the first $2,500 of loss plus one-half of the next $30,000 for a maximum of $17,500 (this applies to tax years that end after March 20, 2013). This means that if your net farm loss exceeds $32,500 you will be able to deduct the full $17,500 from your income. Any excess (known as a "restricted farm loss") can be carried back or forward as shown in Appendix 2. Restricted farm losses can only be used to the extent of farm income in those years. In this way, the benefits from tax losses which often arise in the early years of business - and are accelerated by use of the cash method of accounting – are restricted for part-time farmers when farming is not their main course of income. This is also true for an individual who combines farming with another source of income. See Appendix 1 for summary.

Whether or not farming is the taxpayer's primary source of income has been the subject of endless court cases. The courts have considered time commitment, capital commitment, and expectation of profitability to be determining factors.

You should note that for a hobby farm with no expectation of profit, no expenses are deductible on your tax return.

Exercise 4

Justin has just inherited a woodland (qualifies as a farming woodland). In 2013, he decides to supplement his income from a local garage with income from the woodland. He has decided to purchase a small tractor to use with a trailer to haul wood. In the first year of business, he spends $20,000 on a used tractor and his other costs total $22,000. His loss in the first year is $25,000 (tractor depreciation plus other costs). How much of this is he entitled to claim against his income?

(SEE PAGE 78 FOR ANSWER)

Investment Tax Credits

Investment tax credits are available to farmers and loggers in Nova Scotia for expenditures on "qualified property." This federal tax credit (reduces federal tax on a dollar for dollar basis) is calculated at 10% of the capital cost of eligible assets. The credit must be claimed within 18 months of the tax year end or it is lost. An eligible expenditure must be for a qualifying building or qualifying machinery and equipment. To qualify, the asset must be new and unused at the time of purchase. Property that has been previously owned, used as a demonstrator, or leased is not eligible. The asset must be acquired to be used by the taxpayer in Canada primarily (more than 50 per cent) in the taxpayer's business of farming or logging. (Use in other industries may also qualify but that is outside the scope of this booklet.) Examples of buildings, machinery and equipment that qualify include nearly all structures, machinery and equipment used in farming or logging activities, except for cars and trucks designed for use on highways. However, logging trucks weighing more than 7,258 kilograms will qualify.

Capital cost is the actual cost less any other government or non-government assistance received. HST recovered as an "input tax credit" is not included. The credits are available to all taxpayers regardless of size or legal structure of the business, and can be used to offset federal income taxes payable. If not enough federal taxes are payable against which to claim the investment tax credit, 40% of current year credits earned by individuals and certain corporations are refundable.

Investment tax credits earned but not used to offset federal taxes payable or refunded to the taxpayer can be carried forward/back based on the periods noted in Appendix 2 and claimed against federal taxes in those years.

Here is an example that shows the benefit of investment tax credits. Let's assume the following:

1. Two individuals, Ali and Bert, each acquire a piece of equipment for $60,000 in 2013. Ali uses the equipment in logging (an eligible activity for investment tax credit purposes) whereas Bert uses the equipment in an ineligible activity (perhaps construction).
2. In both cases the equipment can be depreciated at a rate of 30 per cent for income tax purposes.
3. Both individuals are earning profits and have a marginal tax rate of 50 per cent.

The tax consequences are shown in the table on the next page. You will see that claiming an investment tax credit will result in lower capital cost allowance claims in following years.

Tax Consequences of Investment Tax Credit

YEAR 2013	Ali	Bert
Income reduction from capital cost allowance		
$60,000 x 30% x 50% (in year of acquisition)	$9,000	$9,000
Marginal Income Tax Rate	50%	50%
Tax Reduction	4,500	4,500
Investment tax credit claimed: 60,000 x 10%	6,000	
Total tax reduction	**$10,500**	**$4,500**

YEAR 2014	Ali	Bert
Income reduction from capital cost allowance		
Original cost of equipment	$60,000	$60,000
Subtract capital cost allowance to date	-9,000	-9,000
Investment tax credit claimed in prior year	-6,000	
	$45,000	$51,000
Multiply by capital cost allowance rate	30%	30%
	$13,500	$15,300
Multiply by marginal income tax rate	50%	50%
Income tax reduction	**$6,750**	**$7,650**
Undepreciated captial cost available for capital cost allowance in future		
Original cost	$60,000	$60,000
Subtract: investment tax credit claimed	-6,000	
capital cost allowance to date	-22,500	-24,300
Available to be depreciated in future	$31,500	$35,700

Exercise 5

Raymond purchased a new skidder in 2013 at a cost of $200,000. The skidder is used in a farming business and can be depreciated at a 20% rate. Raymond has a marginal tax rate of 30%. What would his income tax reduction be for the year 2013 (assuming enough tax balance owing to offset credits)?

(SEE PAGE 78 FOR ANSWER)

Quiz: Part 1 • Chapter 3

Based on your study of this lesson, please choose the best answer.

1 Persons carrying on a business have no obligation to keep records. ☐ **True** ☐ **False**

2 Government grant revenue received to buy a piece of equipment is used to offset the equipment cost for tax purposes. ☐ **True** ☐ **False**

3 A well maintained cashbook eliminates the need to keep original source documents. ☐ **True** ☐ **False**

4 If you generate records using electronic methods, you can destroy the electronic records as long as a paper copy is kept. ☐ **True** ☐ **False**

5 On woodlands where operations are carried out in such a way that the woodland is not a farming business, income must be reported using the accrual method. ☐ **True** ☐ **False**

6 When timber is removed from a woodland, a deduction against income may be claimed. ☐ **True** ☐ **False**

7 The timing of claiming costs such as repairs and maintenance, depends on the method of accounting. ☐ **True** ☐ **False**

8 If a vehicle is owned in a corporation and used personally by an employee or shareholder, a taxable benefit will need to be included on their personal tax return. ☐ **True** ☐ **False**

9 If money is borrowed to earn income from a business or property, the interest paid may be claimed as a deductible expense. ☐ **True** ☐ **False**

10 Examples of capital assets include ________ , ________ , and ________.

A) **light bulb**
B) **a woodlands**
C) **machine oil**
D) **new barn**
E) **air filters**
F) **tractor chains**

Continued on next page...

11 John has space in his home that is used as a dedicated home office and storage for his business. The total square footage of these rooms is equal to 15% of this total home. He has a power bill $400. How much can he include in his business expenses?

_____ A) **none** _____ B) **$60** _____ C) **$200** _____ D) **$400**

12 Business losses arising from a part-time farming operation can be used to offset any other personal income up to a limit of:

_____ A) **$17,500** _____ B) **$7,500** _____ C) **$8,750** _____ D) **$10,000**

13 If a qualifying asset is purchased and used more than 50% of the time for the farming business, it is eligible for an investment tax credit, whether it is new or used.

☐ **True** ☐ **False**

14 Buildings and equipment that qualify for an investment tax credit equal what percentage of the purchase price?

_____ A) **15%** _____ B) **35%** _____ C) **20%** _____ D) **10%**

(ANSWERS ON PAGE 78)

PART 1 • CHAPTER 4

Miscellaneous Matters

HST

Registration

If a business (proprietorship, corporation or partnership) has sales of taxable supplies in each fiscal year below $30,000, they are considered a small supplier and do not need to be registered for HST or charge HST on sales. If a business has more than $30,000 in sales of taxable supplies in any four consecutive calendar quarters ending March, June, September or December, then that business is no longer considered a small supplier and is required to be registered for HST. For guidance on taxable versus exempt supplies, see CRA ***Guide RC4022 General Information for GST/HST Registrants***.

How HST works

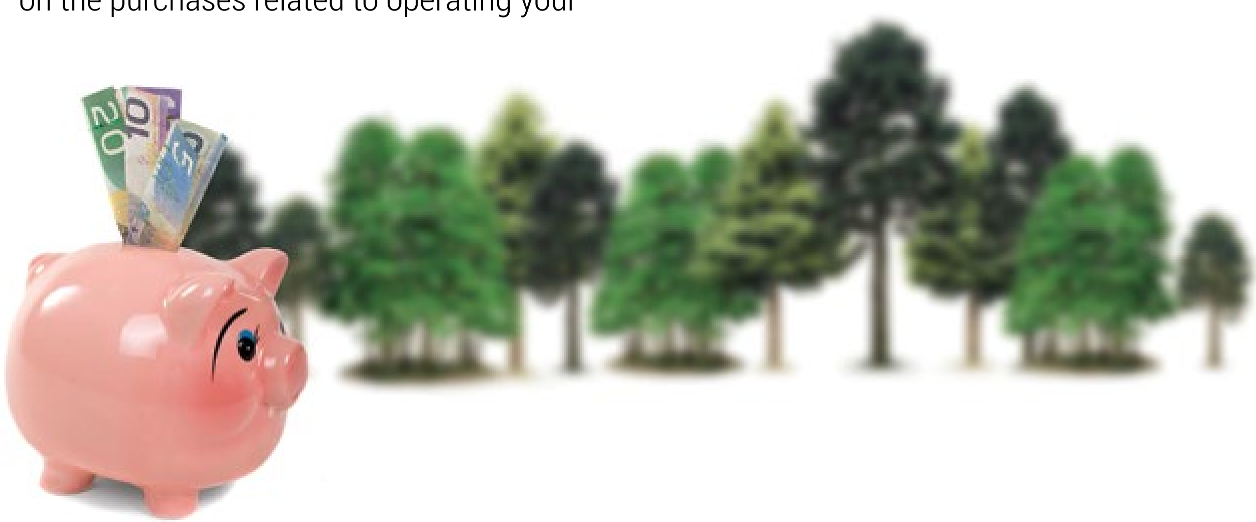
The HST collected on sales is remitted to CRA on a monthly, quarterly or annual basis. The amount to be remitted is equal to the HST collected less the amount of HST paid on the purchases related to operating your woodland. If the total HST collected is less than the total HST paid for the period, a refund will be received for the difference. For example, if you collected $2,300 of HST on sales and paid $2,800 on purchases, then the expected refund from CRA would be $500.

If the business remits HST annually, then quarterly instalments may be required if the net amount owing at the end of the year was over $3,000. If the instalments are not paid, the interest will be added to the amount owing when the HST return is filed.

HST charged on sales

When HST is required to be charged is dependent on the type of revenue and who the customer is.

Whether HST is charged on a stumpage fee, (allowing another party the right to cut the land) depends on if the other party is registered for HST and what they will be using the stumpage for. If the purchaser is also registered for HST and is in the business for



re-selling the wood, then HST is not required to be charged on the stumpage fee. If the purchaser is the end consumer (they will not be re-selling the wood) then HST is required to be charged whether or not the payer is registered for HST.

If you are in the business of logging or farming and you sell hardwood, logs or Christmas trees, these are taxable supplies and you must charge HST if you are registered. Some products are taxable but are zero-rated, meaning that they are subject to HST at a rate of 0%. In relation to woodland owners, zero-rated products include maple products (not including maple sugar candy).

Special rules apply to the sale of farm equipment and property. It is recommended that you ask your tax advisor about what is subject to HST when the situation arises.

HST paid on purchases

The amount of HST paid on purchases is referred to as an Input Tax Credit (ITC). HST is charged on most business related purchases with some exceptions including insurance, interest, bank and credit card fees and tolls. In order to claim HST, it must be shown on the bill or receipt along with the company or individual's HST registration number. If CRA performs an HST audit, any amounts claimed that are not clearly shown on the supporting bill or receipt will be denied and have to be repaid plus interest. The exception to this rule is the payment of a non-taxable per kilometre travel allowance to an employee. HST is deemed to be included in the allowance. For Nova Scotia, the HST input tax credit is calculated as 15/115 of the payment. For example, if a mileage allowance based solely on km driven is paid in the amount of $500, the HST the corporation claims is $500 x 15/115 = $65.22.

Another exception is HST paid on meals and entertainment. For these expenses, generally only 50% of the HST paid can be claimed as an ITC however there are exceptions such as providing a meal that is available to all employees, such as a Christmas party dinner, and for meals at a remote work location or special work site.

Even if sales do not exceed $30,000, woodland owners may voluntarily register for HST in order to claim ITC's for HST paid on purchases used in the business. Depending on your situation, this may be advantageous for you, but you would need to speak with your accountant.

Gasoline Tax

Many woodland owners who are actively involved in their woodlands qualify for a refund under the Revenue Act. At the time of printing, refunds of $0.155/L gas and $0.154/L diesel were available for fuel used in farming and harvesting equipment. It cannot be used in any motor vehicles, ATVs, snowmobiles or other recreational vehicles, whether or not it is registered for highway use.

The refund is applied for on an annual basis by submitting the required form. Alternatively, a permit can be acquired so that the tax is deducted at the time of purchase. The permit can only be obtain if specific conditions are met, including that the fuel is purchased at wholesale with a minimum delivery of 200 litres.

Year End

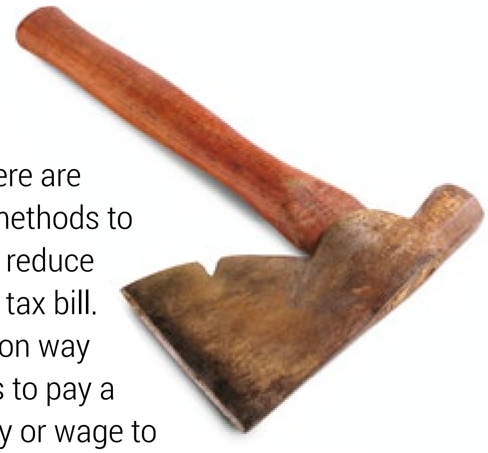
Since 1995, unincorporated businesses (proprietorships and partnerships) have been required to have a calendar year end (December 31) for tax purposes. A corporation may choose any year end, which provides more flexibility. The choice of a corporate year end is made on your company's first tax return. While the first taxation year cannot be longer than 12 months, it can be shorter. You may want to choose a fiscal year end, for instance, to coincide with a down time in your business.

In certain cases, corporate tax may be deferred for the first year of operations by choosing a fiscal year that will postpone the recognition of income to the second year. For example if a business is incorporated in January and income begins to be earned in October, a fiscal year of September 30 could be chosen to obtain a maximum deferral of tax to 15 months after the income is earned.

Another consideration is the availability of your accounting firm. Aligning the year end with your accounting firms' slow period may offer rewards such as a quicker turnaround time on their work.

Income Splitting

In Canada, family members are mostly taxed independently on their income. This, combined with the graduated personal income tax rates, provides an opportunity and an incentive to reduce income taxes by spreading income among family members. Taxpayers and their advisors have devised various ways of splitting income and the Department of Finance has blocked methods they find offensive.



Nevertheless, there are still many valid methods to split income and reduce the family's total tax bill. The most common way to split income is to pay a reasonable salary or wage to a spouse and/or children for their work in the woodland business, or to operate with a spouse or adult children as a partnership. In a corporate setting, family members can participate in the ownership of a business as shareholders or beneficiaries of a family trust that is a shareholder. Dividends can then be paid to the spouse and children over 18, resulting in lower overall taxes. (These methods require careful planning).

Other ways to split income include pension splitting for seniors, making spousal RRSP contributions, low interest spousal loans, and spending the earnings of the higher income spouse, while the lower income spouse saves and invests. This results in investment income being taxed at a lower rate.

On October 30, 2014 the new Family Tax Cut was announced. Starting in 2014, a non-refundable federal tax credit (maximum of $2,000) will be available on a transfer of income (maximum $50,000) to a spouse if you have children under 18 that reside with you.

The benefits of income splitting are shown in this example. Let's assume that an individual operates a woodland and has a taxable income from it of $58,000. The individual's spouse works part-time outside the family business and has a taxable income of $15,000. The spouse also participates in the family business by keeping books and financial records, answering phones, delivering messages, doing odd jobs, and generally helping as much as possible. The spouse has not been paid a salary or wage for these services. By paying the spouse a $10,000 salary and reducing the individual's taxable income by the same amount, the family's total income is unchanged. But there is a big impact on the family's income taxes as shown below.

1. Reduction in individual's income taxes by reduction of taxable income from $58,000 to $48,000.
   $10,000 x 36.95%* = $3,695
2. Increase in spouse's income taxes by increase in taxable income from $15,000 to $25,000, with a 23.79%* **marginal rate**.

$10,000 increase at this level = $2,379

Total income tax savings = $3,695 – 2,379 = $1,316

*See Appendix 3 for **marginal** income **tax rates**.

Claw-Back, Etc.

Several federal programs are subject to an income or means test. For instance, individuals over the age of 65 are generally entitled to Old Age Security (OAS). For 2014, this is approximately $558 per month ($6,696 per year). However, as a senior's income rises above $71,592, the OAS is "clawed-back".

The **claw back** amount is equal to 15 percent of the amount by which the individual's net income exceeds $71,592. Thus for 2014, an individual's OAS will be completely repayable ("clawed-back") when their net income reaches $116,002.

The age tax credit of $6,913 available to seniors is also subject to an income test. This credit against federal taxes is reduced as income increases above $34,873. For 2014 the credit is reduced by 15 percent of the amount of net income of more than $34,873, until it is fully eroded. Once an individual's income level is more than about $80,980 they will no longer be entitled to any age tax credit.

Those who receive OAS may also be eligible to receive the Guaranteed Income Supplement (GIS). The maximum amount

receivable depends on the senior's marital status and whether or not their spouse is also receiving OAS. For a single person, the maximum amount of combined OAS and GIS for 2014 is $757 per month ($9,084 per year). If the recipient is married or common law, and their spouse also receives OAS, the maximum amount is $502 per month ($6,024 per year). If their spouse does not receive OAS, then the amount is $757 per month.

GIS starts to be "clawed-back" if there is any income received in addition to OAS. The amount "clawed-back" depends on the type of income received. For most income sources, each $1 of additional taxable income results in GIS decreasing by $0.50. The exception to this rule is employment income where the first $3,500 does not cost you any GIS. Take for example a person who only has OAS and the GIS as sources of income. In one year, there is a capital gain from the sale of a woodland totalling $10,000 of which only half, $5,000, is taxable. This would reduce the person's GIS by approximately $2,500 for the next year.

Other federal programs that are influenced by family income levels include the "family benefit system," and the "goods and services tax credit."

Many woodland owners (particularly those who sell stumpage) do not have a regular income from the woodland. So, they need to consider how irregular income levels affect the benefits available under these federal programs.

The following are two possible strategies to minimize the effects of these **claw-backs**. The first is to spread the income over several years to avoid any unnecessary **claw-backs** altogether. The second is to crowd as much of the income as possible into one or two years so that the benefits will be lost for only a short period of time. A corporate business structure provides the most flexibility since you can control the amount of income you receive from the corporation in any given year. When choosing a strategy, you should consider your income from other sources and the corresponding **marginal tax rate**.

Filing your taxes on time

If you operate your woodland as a sole proprietor or a partnership, the tax return is not due to be filed until June 15th of the following year, but any taxes owing are due by April 30. If your woodland business is incorporated, you have three months from your year end date to pay any taxes owing and six months to file the corporate tax return.

Interest is charged by CRA at prescribed rates for any late payments on income taxes – the rate for the fourth quarter of 2014 was 5%. Interest and penalties paid to CRA are not deductible for tax purposes. If you do not file the return on time, in addition to interest, you will be charged a penalty. The penalty is calculated as 5% of the tax balance owing, plus 1% per month up to a maximum of 12 months. However, note that if CRA issues a demand to file and you were fined a penalty in any of the last three taxation years, the penalty for the current year would be 10% of the tax balance owing plus 2% for each full month the return is late up to a maximum of 20 months.

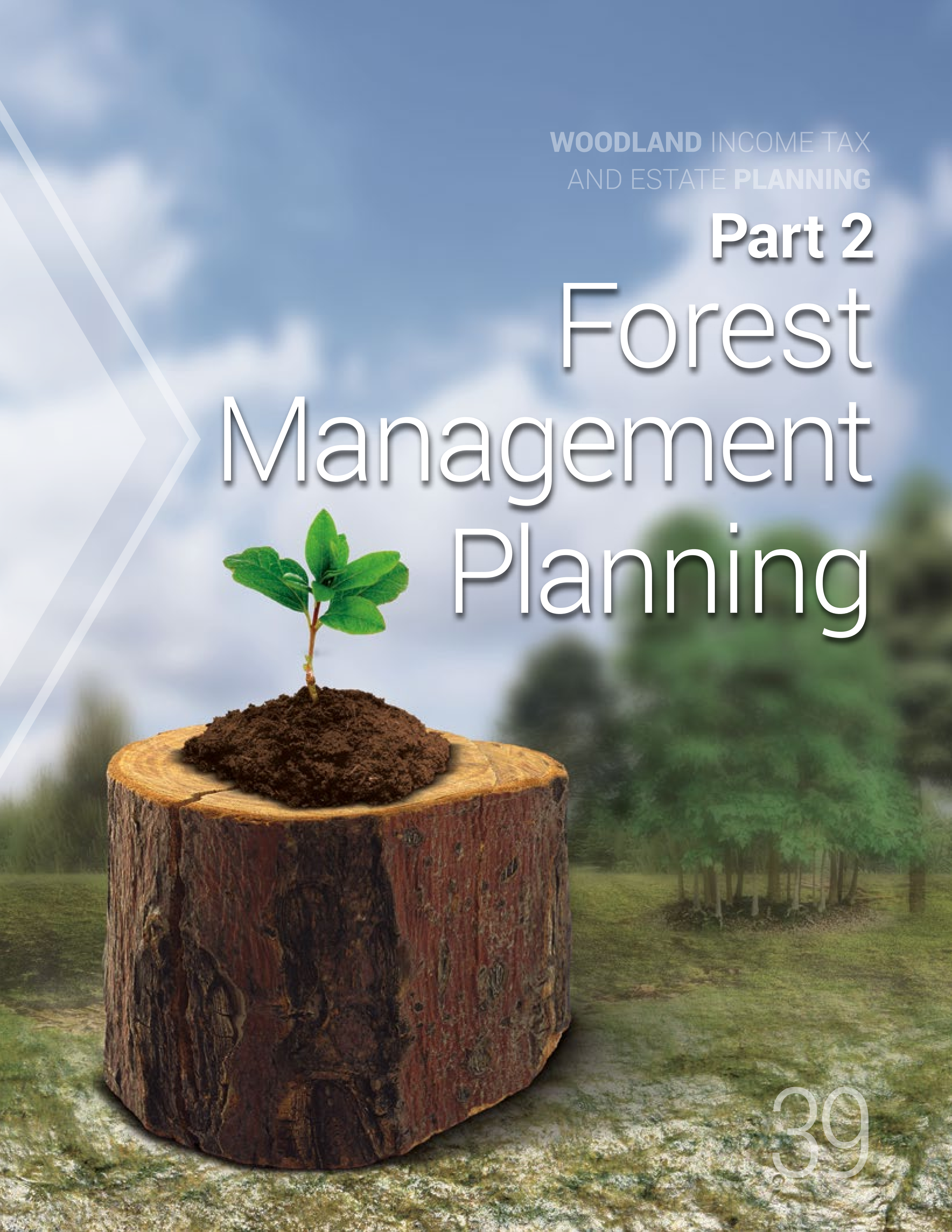
Quiz: Part 1 • Chapter 4

Based on your study of this lesson, please choose the best answer.

1 Partnerships can choose their fiscal year end date.	☐ **True**	☐ **False**
2 Income splitting within a family unit can result in a substantial reduction of income tax owed.	☐ **True**	☐ **False**
3 The most relevant way for a woodland owner to split income is by making spousal RRSP contributions.	☐ **True**	☐ **False**
4 When an individual is 65 and their income is greater than $116,000, he/she will have to repay all of his/her O.A.S.	☐ **True**	☐ **False**
5 Senior citizens receiving O.A.S. and thinking about selling their woodland should consult with a tax advisor well in advance of the stumpage sale.	☐ **True**	☐ **False**
6 As a proprietor, your tax return is due to be filed by April 30th, and your tax payment is due by June 15th.	☐ **True**	☐ **False**
7 You have 6 months from year-end to file your corporate tax return.	☐ **True**	☐ **False**
8 You will be charged penalties on late income tax payments, even if your return is filed on time.	☐ **True**	☐ **False**
9 You must register for HST if your business has more than $30,000 in net income.	☐ **True**	☐ **False**
10 HST must be charged on stumpage fees if the purchaser is also registered.	☐ **True**	☐ **False**

(ANSWERS ON PAGE 79)

Part 2
Forest Management Planning



Prescribed Forest Management Plan

What is a prescribed forest management plan?

A forest management plan is a long-term plan, implemented by a woodland owner that helps to identify the owner's goals and objectives, and what they wish to realize from the property. Some common goals are: wildlife habitat protection, recreation and eco-tourism, soil and water conservation, tree farming and plantation, timber production, special forest production (berries, mushrooms etc.), forage production and future generation investment.

The plan provides an accurate description of existing conditions, and makes recommendations for woodland management activities considering all resources such as water, wildlife and recreation. These activities are prioritized, while adhering to laws and regulations that apply to forest lands in NS.

Further to the above management plan, a prescribed forest management plan, as per Section 7400 of the Income Tax Act is defined as a written plan that either:

a) describes the composition of the woodland, provides for the attention necessary for the growth, health and quality of the trees on the woodland and is approved in accordance with the requirements of a provincial program established for the sustainable management and conservation of forests; or

b) has been certified in writing by a recognized forestry professional to be a plan that describes the composition of the woodland, provides for the attention necessary for the growth, health and quality of the trees on the woodland[13]

This plan must cover a minimum period of five years, and the woodland must be maintained with reasonable regard for what the plan calls for – this means that it is not sufficient to just have the piece of paper you must continue to nurture.

Why is it important?

Done properly, a management plan should provide guidance to the woodland owner on a variety of issues, but it also shows a commitment on behalf of the owner to manage the woodland in such a way that it will be viable. This also allows better access to government programs (discussed later) and provides the documentation necessary to support the 'reasonable expectation of profit' and classification of '**commercial woodland**' as discussed in Part 1 - Chapter 1.

In addition, a prescribed forest management plan is required by an individual who is a woodland owner to transfer woodlands to their children on a tax-deferred basis under the Intergenerational Transfer Rules that we will discuss under Part 3, Chapter 1 – Tax Liability on Death and Chapter 4 – Transfer of Your Woodland During Your Lifetime.

Who prepares the management plan?

Anyone, including the owner can prepare a forest management plan, however in Nova Scotia a prescribed forest management plan must be prepared by a recognized forestry professional. The professional will have a degree, diploma or certificate recognized by the Canadian Forestry Accreditation board, the Canadian Institute of Forestry or the Canadian Council of Technicians and Technologists.

What does a prescribed forest management plan include?

The prescribed forest management plan is prepared by way of a cruise and should include:

- a map showing the location of the land and the property identification number;
- a description of the characteristics of the woodland;
- a description of the development of the woodland, including the activities carried out on the woodland, since the taxpayer acquired it;
- an estimate of the ages and heights of the trees and their species;
- the quantity of wood on the woodland;
- the quality and composition of the soil underlying the woodland;
- the quantity of wood that the woodland could yield as a result of the plan implementation; and
- a description of and timing for harvesting, renewal and regeneration, application of silviculture techniques and stewardship of the environment.[14]

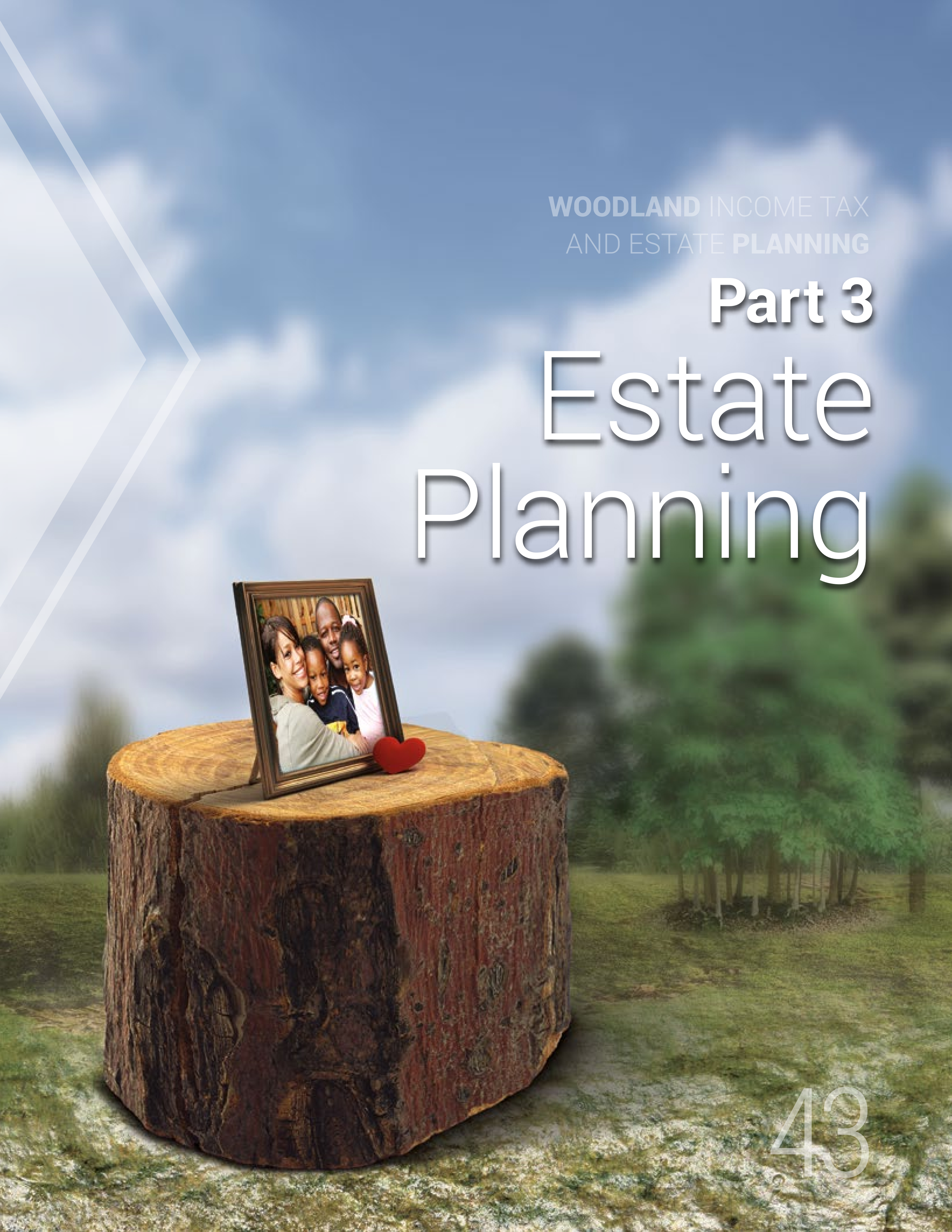
Quiz: PART 2 • Chapter 1

Based on your study of this lesson, please choose the best answer.

1 An owner can prepare their own forest management plan.	☐ True	☐ False
2 Per Canada Revenue Agency, a prescribed forest management plan is required for a minimum of 5 years.	☐ True	☐ False
3 As long as the plan is in writing it qualifies as a prescribed forest management plan.	☐ True	☐ False
4 A commercial woodland that has a qualifying prescribed forest management plan in place that is being followed can be transferred to a child on a tax-deferred basis.	☐ True	☐ False

(ANSWERS ON PAGE 79)

Part 3
Estate Planning



Woodland Tax Liability On Death

How is my woodland taxed when I die?

As a general rule a taxpayer is deemed to have disposed of all property at its **fair market value** on the date of death. Specifically a woodland owner is deemed to have **disposed** of their woodland in this manner. The difference between the **fair market value** and the **adjusted cost base** is a **capital gain**. This could result in large amounts of tax payable and may even require premature harvesting of all or part of the woodland by the beneficiaries in order to obtain enough cash to pay the tax liability.

An exception to the above is a woodland (or any asset) that passes to your spouse or to a **spousal trust**. This property is deemed to be disposed of at your **adjusted cost base**. You should note that this is not tax-free, but rather tax-deferred, as tax will be payable when the property is later disposed of by your spouse.

Your **executor** can elect out of the **adjusted cost base** rule and have property pass to your spouse at **fair market value**. This can be useful in some situations – for example, when there are unused **capital losses** as discussed earlier under the section on the taxation of **capital gains**.

Rollover to the Next Generation - Transfer of Farm Property on Death

There is another exception to the general rule at death, where a transfer at cost may be achieved if an individual transfers eligible farm property to his or her child, grandchild, or great-grandchild. (Note: as discussed earlier, a woodland can qualify as a farm business). To qualify for the transfer at cost, the following conditions must be met:

- The farm must be located in Canada;
- The child or the individual must be resident in Canada immediately before the transfer takes place; and
- Prior to the transfer, the property must have been principally used in the business of farming and the individual, the individual's spouse or common-law partner, or any of the individual's children must have been actively engaged in farming on a regular and continuous basis.[15]

"Principally used" is not defined in the Income Tax Act. However CRA has said that for administrative purposes, it means more than 50%, both from a time perspective and a usage point of view. As there is no requirement that the property be used in a farming business immediately before the transfer, a property that is used for another purpose prior to the transfer may still be eligible, depending on the facts of the situation. Note also that there is no requirement that the child continue to use the farm property in the business of farming after its transfer in order to qualify for this rollover.[16]

As per Section 73 of the Income Tax Act, the above farm rollover has been extended to include commercial woodland operations as long as they meet the following criteria, in addition to the criteria listed above:

- Before death, the property was used in the operation of a woodland to the extent required by a Prescribed Management Plan; and
- As a consequence of death, the property is transferred to and becomes vested indefeasibly in the child within the period ending 36 months after the death.[15]

If these requirements are met, the **executor** of the estate can choose the proceeds to be reported for land anywhere between **adjusted cost base** and the **fair market value**. For **depreciable property** transferred to a child, such as a building or equipment, the parent's deemed proceeds can range anywhere between the **undepreciated capital cost** of the property and its **fair market value**. If **undepreciated capital cost** is chosen, no **capital gain** or **recaptured depreciation** results. The child's **adjusted cost bas**e is equal to the parent's deemed proceeds - so the child simply takes over the parent's position. No change occurs in the tax situation of the property at the time of the parent's death.

Instead of a rollover, a **capital gain** could be deliberately triggered to use up previous **capital losses**, or to take advantage of the capital gains deduction, described below, which is available on death as well as when the property is transferred or sold.

The Capital Gains Deduction and Dispositions

The sale, transfer, or deemed **disposition** on death of **qualified farm property** is eligible for the "enhanced" capital gains deduction (to a maximum of $800,000 as of 2014, indexed annually for inflation after 2014). The full capital gains deduction will shelter the tax on up to a $400,000 **taxable capital gain** (half the maximum capital gains deduction as half of a **capital gain** is taxable)**.** The capital gains deduction for **qualified farm property** is very important when planning for farms that have woodlands. Some woodlands will also be **qualified farm property,** if a prescribed management plan is followed for a woodland that otherwise meets the definition of a commercial business. As previously noted, CRA has stated that a Christmas tree farm, a maple products operation, reforestation and other types of woodlands could be farming property and so may qualify for the capital gains deduction.

To meet the Income Tax Act definition of "**qualified farm property**" several criteria must be met, related to: the owners of the property, the users of the property, the types of property, the use of the particular farm property, and in certain situations, an objective revenue test.

In general, **qualified farm property** may include:

- land, building and depreciable property used in carrying on a farm business;
- a share of the capital stock of a family farm corporation; or
- an interest in a family farm partnership.

If the farm property was last acquired before June 18, 1987, it will be **qualified farm property** provided it was used principally (i.e. more than 50%) in the business of farming by you or a qualified user (which includes a spouse, common-law partner, child, grandchild, or parent, family farm corporation, family farm partnership and certain personal trusts) in the year the property was disposed of, or in at least 5 years during which the property was owned by the eligible owner (you, your spouse, common-law partner, child, grandchild, or parent, family farm partnership or certain Personal Trusts).

If the property was last acquired after June 17, 1987, the requirements of the **qualified farm property** definition become more difficult to meet. The first condition that must be met is that the land must have been owned by you or one or more qualified owners (which include a spouse, a child/grandchild or parent, or certain Personal Trusts) throughout a period of at least 24 months immediately preceding the **disposal**. The second condition is that in at least 2 years during the period the land was owned by a qualified owner (referred to as the "operator"); the gross revenue of the operator from the farming business must have exceeded the operator's income from all other sources for that period. Also, the land must have been used principally in the farming business in which the operator was actively engaged on a regular and continuous basis.[17]

Certain triggering events may cause the more stringent post-1987 rules to apply. For example, in 1994 taxpayers were given the option to **crystallize capital gains** to use up the $100,000 capital gains deduction that was being eliminated. Any property that was re-valued at this time is considered to have been sold and re-acquired in 1994. So, if you purchased the land prior to June 18, 1987 but used is as part of this 1994 election, it is considered to have been "last acquired" after June 17, 1987 and the more stringent rules will apply.

The $800,000 capital gains deduction also applies to **qualified small business corporation shares**. These are shares of a **Canadian controlled private corporation** where all, or substantially all, of the assets are used in an active business carried on primarily in Canada. The shares must be held for at least two years by Canadian residents, and at least 50 percent of the **fair market value** of corporation's assets must be used in an active business carried on primarily in Canada during those two years. The rules become more complex if there are several corporations involved and/or the majority of shares are owned by non-residents. There is an exception to the two-year holding period when you incorporate a previously unincorporated business. If the assets you transfer to the corporation are all used in the business, then the shares qualify immediately.

Subsection 85(1) of the Income Tax Act allows the transfer of assets to a corporation without an immediate tax cost. Incorporation provides access to the capital gains deduction. For example, if you have been actively managing your woodland as a commercial business such as logging, the woodland itself may not meet the criteria for **qualified farm property**. You could transfer the woodland to a new corporation and be able to take advantage of the capital gains deduction. Upon death there would be a deemed **disposition** of the shares, which would be eligible for the capital gains deduction whether or not your woodland is a farming business.

Corporations that have been in business for some time often acquire property that is not used in the business (investments in securities or rental real estate, for example). These investments may not qualify as active assets of a family farming corporation or a **small business corporation** and therefore the corporation may no longer be eligible for the capital gains exemption. There are ways to "purify" a corporation so its shares will qualify for the capital gains deduction. This type of tax planning needs to be done well before you dispose of your woodland. Seek further professional advice if you wish to do this.

Quiz: Part 3 • Chapter 1

Based on your study of this lesson, please choose the best answer.

1 On passing away, as a general rule one is deemed to have disposed of all property at cost. ☐ **True** ☐ **False**

2 On death, property that passes to your spouse or spousal trust, creates a tax-deferred transaction. ☐ **True** ☐ **False**

3 A maple products operation cannot be considered as a qualified farm property. ☐ **True** ☐ **False**

4 When transferring eligible or qualified farm property to a child as per your Will, the transfer can range from the adjusted cost base to the fair market value. ☐ **True** ☐ **False**

5 A Prescribed Management Plan is required for a commercial woodland that is not otherwise a farm to fall within the Intergenerational Transfer rules. ☐ **True** ☐ **False**

6 In calculating the tax liability of an asset, ________ is subtracted from ________ .

A) original cost **B) fair market value**

7 The capital gains deduction for 2014 and subsequent years is:

____ **A) $400,000** ____ **B) $500,000** ____ **C) $800,000** ____ **D) $1,000,000**

(ANSWERS ON PAGE 79)

Successful Estate Planning

Benefits of planning ahead

Often people pass away without making plans for the future. This can cause confusion and sometimes legal or other costs at a difficult time for the family. It can also result in significant taxes being due from the estate that might otherwise be reduced, avoided, or deferred with better planning, as was highlighted in Part 3 - Chapter 1. Estate planning is essential. Planning now can ensure that your wishes are honoured when you are gone.

The Estate Planning Team

Estate planning can be complex, and ensuring the plan is properly implemented is crucial to its effectiveness. Assistance of several professionals may be required, including a lawyer, an accountant, a financial planner, and an insurance agent. It is important the individuals that you select have a solid expertise in estate planning. Some questions that you may wish to ask potential advisors would include, but are not limited to:

- Do they have a professional designation or a relevant degree?
- What is their experience – how long have they been practicing estate plans?
- Have they put into practice estate plans with similar complexity to yours?
- Are they aligned with certain financial services products (i.e. specific insurance companies) or do they receive a commission for sales of one product over another.

Time and money will be saved if you are able to gather all the necessary materials before you visit an advisor or begin to plan the estate. The following is a list of materials you should have:

- family details: age, marital status, involvement in woodland or other business interests;
- current will if you have one (if not, consider drawing one up as part of the process);
- list of assets: cost, (**V-day value** if applicable), and market value;
- any appraisals or other valuation information;
- list of liabilities: amounts, security given, and repayment terms;
- details on form of ownership of assets: personal, corporate, partnership;
- financial statements and tax returns for several years;
- ·details of life insurance policies;
- copies of partnership agreements or share buy/sell agreements;
- RRSP's, pension plans, etc.

The Estate Planning Process

Setting Objectives

The starting point for any estate plan is to determine your objectives. You need to know where you want to go before you can develop a plan to get there. As the planning process unfolds, it will become clear what you can and cannot do. It will also become clear that you may need to modify some of your objectives. But you should start with a general idea of what you want to do.

The first objective of most estate plans is to provide adequate cash flow to your spouse or any dependents and pay off any liabilities. Other common objectives are to maintain family ownership of a particular asset such as a family business or a woodland, or to have the ecological features of the woodland preserved by donating it to, or granting an easement to, a conservation authority.

Most people are concerned that they treat their children equitably, or fairly. Equitably does not necessarily mean equally. You do not have to subdivide your woodland so each of three children gets a small woodland of their own. And, it makes little sense to transfer a woodland to a child who has no interest in managing it - especially if another child does. Depending on the circumstance, equitable treatment might involve leaving the woodland to one child and cash or life insurance to another. It is obviously very important to talk to your children about their interests and concerns.

Listing Assets

To plan your estate you have to know what it will consist of. You need to make a list of all of your assets. Some things, such as household effects, can be grouped by type. But any asset that might be disposed of individually should be listed individually. A woodland, for example, would be listed individually.

As well as identifying the assets themselves, you need to estimate the **fair market value** of each one. In some cases it is worth getting formal valuations or appraisals but in many others you can make a reasonable estimate yourself. Knowing the value of your assets makes an even-handed distribution of your estate easier. It also makes it easier to estimate the taxes payable.

It is important to list the original cost of the assets, as this is used to calculate the tax liability. This information can be difficult to find, so the estate planning process is a good opportunity to create an accessible record.

Listing Liabilities

Your estate consists of your assets minus your liabilities. Your liabilities may include mortgages on land, equipment loans, etc. Part of the process of planning your estate is to develop a plan to deal with your liabilities at death. Often the most significant liability at death is the result of income tax.

Developing and Implementing the Plan

With this information, you are ready to develop a working plan. Modify your objectives as it becomes clear what is practical and rework the plan until it meets your needs and wishes. The plan should be reviewed periodically as family situations, assets held, and objectives change over the years.

Implementing the plan will require a Will. More complex situations might require the formation of trusts or corporations, reorganizing existing corporations, acquiring life insurance and so on.

By planning for tomorrow today, you can retain more of your assets, protect your estate, leave a lasting legacy for your family, and in many cases give a major gift to your favourite charity without reducing significantly other aspects of your bequests. A common misconception is that only the wealthy need concern to themselves with estate planning. This misconception can result in significant unnecessary costs to the estate and additional burdens for survivors. Just about everyone can benefit from the development of an estate plan. Young or old, wealthy or middle class, an estate plan can simplify and speed the transition of assets to the next generation, ensure that beneficiaries are protected and reduce the taxes and expenses of an estate.

The next sections will describe not only estate planning tools but also how to transfer your woodland during your lifetime in a tax effective manner.

List each of your assets along with its fair market value, original cost, and difference.

Asset	Fair Market Value ($)	Original Cost ($)	Difference ($)

List any liabilities with security give, value, and repayment terms.

Liability	Amount Owing ($)	Security Given	Repayment Terms

Estate Planning Tools

Wills

Your Will is the basic document in estate planning. The Will determines how the estate will be distributed. In it, you can direct that a specific property (including a woodland, a favorite fishing rod or a specific amount of cash) go to a certain person. The Will also determines the distribution of the rest of your estate - the residue that is left after specific bequests have been dealt with.

More complex Wills can provide for the establishment of various trusts and may give very specific direction as to the **disposition** of assets. That is, your Will may specify exactly how and when your assets will be disposed of, who gets them, and under what conditions.

In your Will you appoint an **executor** to manage your estate. You can have co-**executors** if you feel more than one person is required to carry out your wishes. An **executor** is generally a family member, but can be a friend, a lawyer or a trust company. Being an **executor** is a serious responsibility so you should choose yours carefully, and you must be sure they are willing to accept the appointment. The Will should give the **executor** the power to make any income tax elections (choices) that they deem advisable.

Your spouse has an interest in all of the family's assets under the **Matrimonial Property Act**. She or he is entitled to enforce the scheme of distribution of property under the Act rather than following the terms of the Will. In other words, what you put in your Will may be over-ridden by the rules of this Act, unless a marriage contract is in place. So it is important to involve your spouse in the whole estate planning process.

If you die without a Will, or **intestate**, your estate will be distributed according to a statutory plan. If you are survived by a spouse, the first $50,000 of your estate goes to the spouse. If your spouse and one child survive you, the spouse and child would share equally in any part of the estate over $50,000. If two or more children and a spouse survive you, one-third of the assets over $50,000 go to the spouse and two-thirds to the children. If there is no spouse the estate is split equally among the children. This may not be what you wish; the cost of administration of the estate increases; and it may cost more in income tax and professional fees in the event of death without a Will. As such planning should include everyone who might be affected by the provisions of your Will.

You can write a Will on a piece of paper or you can buy a kit that shows you what to do. However most lawyers charge fairly modest fees for a simple Will and it is worth the cost to be sure it is done right.

Power of Attorney

Before your death, you may become incapable of managing your affairs. Your family can get permission from a court to manage them, but this is a costly, time-consuming process. It is better to give someone a power of attorney. This is a document that gives them the right to manage your affairs, or certain aspects of them, if you become incapacitated. It requires legal advice, and should not be left too late.

Trusts

A trust is a relationship where one person (**the trustee**) holds property for the benefit of another person (the **beneficiary**). There can be more than one **trustee** and/or more than one **beneficiary**.

A trust is created by a person called the **settlor**. The **settlor** transfers property to the trust by means of a trust agreement. The trust agreement governs how the trust will operate, including how income and capital will be distributed. Each trust agreement is unique and this provides quite a bit of flexibility. The **beneficiary** of a trust owns the trust but does not manage it.

Testamentary trusts

A testamentary trust is one that arises on and as a consequence of a person's death and are created under the terms of a person's Will. Currently, these trusts receive special tax treatment including a non-calendar year end, no installments, and graduated tax rates.

Often, tax plans call for the creation of multiple testamentary trusts, such as one for each **beneficiary**. For example, for a spouse to have the income from assets taxed in a separate testamentary trust could not only significantly reduce the tax burden, but could keep the spouse's income low for OAS claw back or other income tests benefits.

Effective January 1, 2016, testamentary trusts will be subject to tax at the highest

personal tax rates, with the exception of certain graduated rate estates and Qualified Disability Trusts.

The graduated rates will continue to apply for the first 36 months of an estate that arises as a consequence of an individual's death. If the estate remains in existence more than 36 months after the death, it will become subject to flat top-rate taxation after that 36 month period.

A second exception applies to trusts having individuals who are eligible for the federal Disability Tax Credit as beneficiaries (a Qualified Disability Trust).

In addition, testamentary trusts that do not already have a calendar taxation year will have a deemed taxation year-end on December 31, 2015 (or in the case of an estate for which that 36 month period ends after 2015, the day on which that period ends). Testamentary trusts will also be required to remit tax payments on an installment basis beginning in 2016.

Inter vivos trust

A discretionary family trust is an "inter vivos" trust, which means it is created during the lifetime of the person who contributes property to the trust. This form of trust is generally used in effecting an **estate freeze**. The **beneficiaries** are primarily the members of one family (including by marriage), the distribution of trust income and/or capital is within the complete discretion of the **trustees**, and the trust property often consists of shares of one or more private companies.

The benefits of a trust can include income splitting with family members, access to multiple capital gains deductions, deferring **capital gains** (otherwise resulting from deemed disposition) until death of spouse, access to multiple marginal taxation rates (testamentary trusts only), creditor protection, and to separate control from beneficial owners.

Trusts are used in specific situations, such as when transferring property to a minor child. A trust is often used to manage an investment portfolio for the benefit of a spouse or child who lacks financial skills or responsibility. Another use of a trust would be to transfer the beneficial ownership of a woodland to children who are not yet ready to manage it.

The drawback of using a trust is that the transfer of property to the trust is a **disposition** of property and may create some immediate tax liability. This is something you can discuss further with your professional advisor.

Another particular type of trust is referred to in the Income Tax Act as a **spousal trust**. A **spousal trust** is one where no one but your spouse may benefit from the income or capital of the trust during the spouse's lifetime. When the spouse dies, the remaining capital of the trust is distributed to the other **beneficiaries**, usually your children.

A spousal trust can be used to provide income for the spouse to live on, while passing the capital (the original money or other assets in the trust) on to the next generation.

Life Insurance

Life insurance can serve a number of purposes in estate planning.

When you pass on, it can provide cash flow to allow your spouse and dependents to maintain their lifestyle while they are still young. It can provide ready cash to pay estate liabilities – you may have significant liabilities that will need to be met from estate funds. It can also provide the cash to pay taxes rather than forcing your survivors to sell a property you wish to remain in the family.

Finally, many people simply want to leave something to their children. Life insurance is a way for you to save up this inheritance and be sure that it will be paid if you die prematurely.

All life insurance policies have a **beneficiary** or beneficiaries. Usually the **beneficiary** is a specific person or persons, but it can also be your estate. If it is your estate, control of the proceeds of the policy is dealt with by your **executor**.

If your business is in a corporation, the life insurance can be structured with the corporation as owner and **beneficiary** of the life insurance policy. Insurance premiums that are paid by the corporation are not deductible unless the policy is required to be in place for financing. However, the benefit is that the premiums are paid within the corporation rather than with after personal tax dollars. The death benefit flows out of the Estate on a tax-free basis.

Quiz: Part 3 • Chapter 2 And 3

Based on your study of this lesson, please choose the best answer.

1 Income and capital from a spousal trust pass on to the spouse during the lifetime of the spouse who created the trust. ☐ **True** ☐ **False**

2 Estate planning eliminates the need for a will. ☐ **True** ☐ **False**

3 The simplest way to implement an estate plan is with a trust. ☐ **True** ☐ **False**

4 Careful estate planning could reduce taxes that the estate is liable for. ☐ **True** ☐ **False**

5 Once you develop an estate plan, you cannot make any changes and must follow this plan through. ☐ **True** ☐ **False**

6 Estate planning includes making a list of all the assets you own or have an interest in. ☐ **True** ☐ **False**

7 It is not important to include your spouse in the estate planning process as he/she will receive all assets under the Matrimonial Act. ☐ **True** ☐ **False**

8 Power of Attorney refers to the appointment of one person to carry out the affairs of another. ☐ **True** ☐ **False**

9 Passing away without a will is known as dying ______.

____ **A) in estate** ____ **B) intestate**

10 The person who holds the trust is known as a ______.

____ **A) trustee** ____ **B) beneficiary** ____ **C) settlor**

(ANSWERS ON PAGE 79)

Transfer of Your Woodland During Your Lifetime

How is my woodland taxed if transferred during my lifetime?

The general rule is that if you sell, gift or transfer your woodland, it is deemed to have taken place at **fair market value**.

We discussed earlier that on death your woodland can be transferred to your spouse at the **adjusted cost base**. If instead you chose to transfer the property during your lifetime, it is treated the same way, i.e. it is deemed to be disposed of at your **adjusted cost base**. Complex rules known as **attribution rules** prevent the transfer of income and **capital gains** between spouses.

Here is a simple example. If your woodland cost $7,000, for example, and is now worth $55,000: you could transfer it to your spouse with no immediate tax cost. You would be deemed to have disposed of the woodland for $7,000 so you would have no gain or loss. Your spouse would be deemed to have a cost of $7,000. If your spouse then sold the woodlot for $55,000 there would be a $48,000 **capital gain** of which one-half ($24,000) would be taxable in your hands.

If the actual sale of the woodlot you transferred to your spouse takes place after your death, the gain will be included in your spouse's income – regardless of whether the property passed to your spouse during your lifetime or on your death.

Rollover to the Next Generation – Transfers of Farm Property During Lifetime

The Income Tax Act allows transferring eligible farm property to a child on a rollover (tax deferred) basis during his or her lifetime (known as an inter-vivos transfer) as an exception to the general rule.

The conditions for an inter-vivos rollover are the same as was discussed in Part 3, Chapter 1, Rollover to the Next Generation – Transfers of Farm Property on Death. Again, the conditions allow for commercial woodland operations to fall within the rules if a Prescribed Management Plan is being followed, even if the woodland would not otherwise meet the farming definition.

The difference here is that if the rollover is considered a gift (i.e. no cash changing hands), there is no flexibility and it transfers at cost, whereas on death, the transfer can take place at any amount between the cost and **fair market value**.

Triggering a Capital Gain

At times, it is a good idea to trigger a gain in the parent's hands to step up the cost base to the child. A parent would do this if they had access to the capital gains deduction or had unused losses as previously mentioned.

Above, it was just pointed out that there is no flexibility if no "sale" is taking place. However, a gain can be realized for **qualified farm property** (as defined in Part 3, Chapter 1). For example, consider if instead of a cash payment the child gives the parent a promissory note for the purchase price, which could range from the cost up to the fair market value. The parent could forgive the promissory note from the child on death in their Will. We will look at a simple example below.

Let's assume you bought your woodland in 1990 for $10,000 and have been following a prescribed forestry management plan with commercial intent. The property is now worth $40,000. If you gift your child the woodland during your lifetime, there will be no gain or loss for you and the cost base of $10,000 transfers to your child.

Now let's assume the same scenario, except that the woodland also qualifies for the capital gains exemption (is qualified farm property). Instead of giving the woodland to your child (in which case it must be transferred at your cost) you could sell the woodland to him or her.

In this scenario you can set the selling price anywhere between your cost ($10,000) and **fair market value** ($40,000), but you must receive consideration (payment) equal to the selling price. Typically, in this situation the consideration is a note payable from the child. You have the right to demand payment within the terms of the note, but you may choose to hold the note and gift it back to the child in your Will, with no tax implications.

If you set a selling price of $40,000 the full **capital gain** on the sale would be sheltered by the capital gains exemption. The cost of the property to your child would be $40,000, instead of $10,000 in the first example. This would reduce your child's taxes when he/she eventually disposes of the property. Note that forgiving the note during your lifetime may trigger tax for your child.

Although this example used the capital gains exemption, it could have just as easily used a **capital loss** (remember **capital losses** can only be deducted from **capital gains**). The **capital loss** would be offset with the gain that was triggered, and tax could be reduced or eliminated.

Exercise 6

Ashley bought a woodland in 1991 for $15,000 (woodland is qualified farm property). The property is now worth $30,000.

A) Considering tax implications for her and her daughter, is it best to give the woodland to her daughter now or will it to her when she dies?

B) If Ashley has available capital gains deduction of $7,500 would this change things? If so, how?

(ANSWER IS ON PAGE 79)

Because the **capital gain** is a component in determining “income” which is then offset by the capital gains deduction only for the purposes of determining “taxable income”, any income sensitive tax related items may be affected. These might include tax credits, claw back of Old Age Security, and minimum tax.

Depending on your other sources of income, the **alternative minimum tax** rules may result in a tax liability. Although you should be aware of this as you are planning transactions, it is important to note that this tax is refundable in future years when a taxpayer has taxable income. Also, a gain can often be spread out over two or more years so that **alternative minimum tax** implications are avoided altogether; and the rules do not apply for the year of death. So, **alternative minimum tax** should always be considered and planned for, but is usually not a deal breaker.

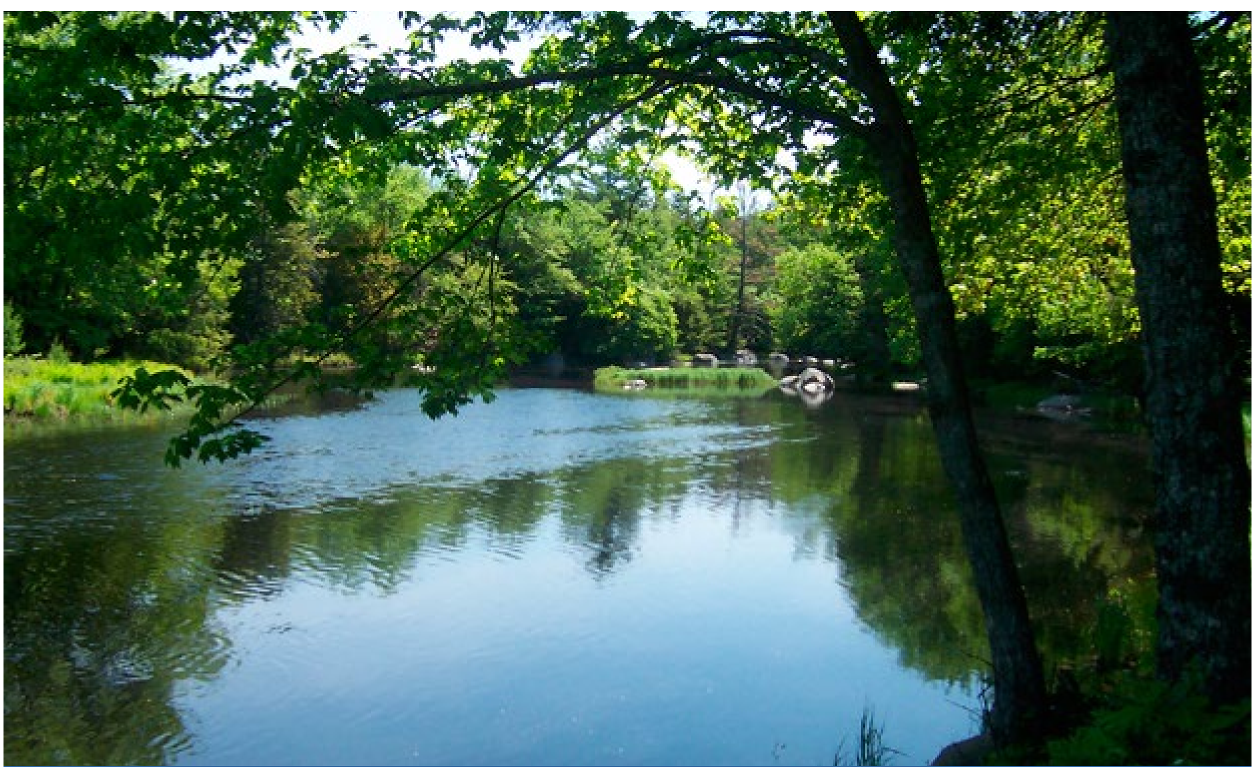
Crystallization

Taxpayers may be concerned that the enhanced capital gains deduction will be replaced, or that the shares of a corporation will not qualify at the time a **disposition** occurs.

To avoid this, the capital gains deduction can be crystallized. This is done by making a transaction that will trigger a **capital gain** that is sheltered by the capital gains deduction which increases the **adjusted cost base** of the property by the amount of the gain.

Examples of **crystallization** transactions include transferring a woodlot that qualifies as a farm to a trust for the benefit of your children, or reorganizing the share capital of a **small business corporation**.

Crystallization transactions should not result in any income tax payable, but as previously noted, they do result in an



increase in net income which can cause a **clawback** of Old Age Security or a loss of the Guaranteed Income Supplement. They can also result in **alternative minimum tax**. You should consider all these factors when planning this type of transaction.

These transactions, like those that are used to purify a corporation, are complex and should not be undertaken without professional advice.

Estate Freeze

If you own an asset that will increase in value over time, then an **estate freeze** may be in order. An **estate freeze** is most common in a corporate setting.

In a typical **estate freeze**, the parent locks in, or 'freezes' the value of the company in their hands at a point in time by exchanging their common shares of the family corporation for preferred shares having a fixed value equal to the fair market value of the company, and then having the family member or family trust subscribe for new common shares for a nominal value. Since the value of the parent's preferred shares is fixed, any future appreciation in the asset will accrue to the holders of the common shares of the corporation.

The preferred shares will have a built-in **capital gain**. There is no way for the parent to avoid the gain that has already accrued, unless these shares are sold to an unrelated party and the shares are eligible for the capital gains exemption.

The parent will often hold a class of shares that has nominal value but a high number of votes so that they control the corporation during their lifetime, or until the preferred shares are redeemed or sold.

An estate freeze is an effective tool to reduce a taxpayer's tax liability on death because the freeze preferred shares can be redeemed over time to provide cash flow to the parent (dividend income) and the tax liability on future growth becomes that of the next generation.

Quiz: Part 3 • Chapter 4

Based on your study of this lesson, please choose the best answer.

1 The general rule is that the transfer of a woodland is assumed to have taken place at the:

____ **A) original cost** ____ **B) fair market value** ____ **C) adjusted cost base**

2 When a parent gifts a farm woodland to their child during their lifetime, there are no changes to the tax situation. ☐ **True** ☐ **False**

3 There is no advantage to trigger a gain on the rollover of a woodland to a child. ☐ **True** ☐ **False**

4 A child does not qualify for the Intergenerational Transfer rules if they intend on selling the woodland immediately after. ☐ **True** ☐ **False**

5 Crystallization transactions will not result in a claw-back of OAS. ☐ **True** ☐ **False**

6 In an estate freeze, any future increase in the value of the asset will be passed on to the children or the spouse in some cases. ☐ **True** ☐ **False**

(ANSWERS ON PAGE 79)

Other Things to Consider When Planning Your Future

The Need for Long-term Care

You may, particularly later in life, require long- term care services. These services could be provided at home or in a residential facility such as a nursing home or special care home. They can be very expensive. If you are unable to pay for these services yourself you may receive assistance from the Department of Health.

The Provincial Department of Health and Wellness determines whether or not you are eligible for financial assistance for the costs of long-term care by performing an income-based financial assessment using your most recent income tax information. If you are single, the Department considers 100% of your income. If you have a spouse (married or common-law) or dependents, the Department considers the net income of the family unit on a graduated scale.

If you harvest and have business income or a **capital gain** from your woodland, this will affect the income test. For example, if you have a large one-time **capital gain** from the sale of your woodland the year you need long-term care, you may not qualify for financial assistance. However financial reviews are done annually and you may be eligible in the following year.

Donating Your Woodland to Charity

You may benefit a charity by donating your woodland. Donation of land to a conservation authority is of particular interest to woodland owners, but donations can be made to other charities as well. You could also donate a conservation easement to a conservation authority rather than the whole property.

A gift is a **disposition**. With the exception of gifts of ecologically-sensitive land, which we will discuss later, the deemed (assumed) **proceeds of disposition** will be the **fair market value** of the property donated. This can result in a **capital gain**.

You receive a charity tax receipt for the **fair market value** of the woodland on the day of transfer. The charitable donation tax credit on the first $200 of charitable donations is a credit at the lowest tax rate, about 24% in Nova Scotia, and the rest earns credit at the top rate, about 50%.

The amount of donation that can be used for credit in any given year is equal to 75% of your net income plus 25% of any **taxable capital gain** that results from a charitable donation. This ensures that all of the **capital gain** will be eligible for credit in the year the donation is made. Any unused amount can be carried forward for five years.

Donating a woodland to charity produces a tax saving since only 50 percent of the capital gain is taxed, while 100 percent of the value of the woodland at the time of transfer earns credit as a donation. This can be a big advantage, especially if you have unused **capital losses** or enhanced capital gains deduction that can shelter the **capital gain** from tax.

Example

Susan has a net income of $60,000 and donates a woodland worth $50,000 to charity. Susan originally purchased the woodland for $15,000.

Capital gain:

Proceeds of disposition	**$50,000**
Adjusted cost base	**15,000**
	35,000
Taxable capital gain: 50%	**$17,500**
Tax on gain (@ 40%)	**$7,000**
Tax credit for charitable donation:	
On the first $200 @ 24%	**$ 48**
On the balance	
($50,000 - $200) @ 50%	**24,900**
	$24,948
Tax saving	**$17,9481**

1. The credit cannot exceed Susan's actual tax, which will be less than $24,948 due to graduated tax rates and other credits and deductions. Therefore some of the donation would have to be carried forward and used to reduce tax in future years. You have up to five years to claim the tax credit from a donation.

Exercise 7

Danny donates 40 acres of land worth $25,000 to a registered charity. The total 100 acre woodland cost him $40,000 when he purchased it. Assuming the 40 acres donated was worth 2/5 of the purchase price when he bought it, what are the tax implications of the donation? Assume a marginal tax rate of 40%.

(ANSWER ON PAGE 79)

A donation of a woodland to a charity could be made during your lifetime or it could be made by way of bequest in your Will.

Gifts of Ecologically-Sensitive Land

Your woodland may qualify as a gift of ecologically-sensitive land – also known as an eco-gift. These are gifts of land that have been certified by the federal Minister of the Environment as important to the protection of Canada's environmental heritage. The gift must be made to a public charity that is designated by the federal Ministry of Environment. In order for the land to meet the qualifications, it must have natural features, wildlife habitats or other heritage values. In addition, the land has to be certified by the Ministry of Environment as ecologically sensitive.

By gifting a qualified woodland, you receive a charity tax receipt for the **fair market value** of the woodland on the day of the transfer. The benefit of this program is that there is no **capital gain** on the **disposition**. The tax credit is limited to your annual income and has to be used within five years.

Using the same example as before, but now assume the land Susan donates is ecologically-sensitive land. The full tax savings of $24,948 would be realized, without the tax on the gain.

Probate Fees

In most cases, the **executor** will want to have the Will probated. That means the courts will review the documentation to determine whether it is valid and allow the executor to follow the directions given in the Will. This gives the **executor** a better legal status to deal with some aspects of the estate and some confirmation that they have acted appropriately.

The schedule of fees payable to probate a Will in Nova Scotia is as follows:

Value of Estate	Fee
Less than $10,000	**$ 83.10**
$10,001 - $25,000	**$208.95**
$25,001 - $50,000	**$347.70**
$50,001 - $100,000	**$973.45**
Over $100,000	**$973.45 + $16.45 per additional $1,000**

Probate fees are based on the value of the estate, so if the estate value can be reduced, the fees will be reduced. There are several ways to do this.

Real property (land and buildings) held in joint tenancy passes directly to the survivor without going through the estate. Joint tenancy options were discussed in Part 1, Chapter 2 – 'Who Reports the Income'.

Transferring assets to a trust will also remove them from the estate and avoid probate fees. As we discussed earlier, this is quite complex and may not be suitable in many cases.

As was noted earlier, life insurance can be made payable to your estate. This increases the estate, so it is more typical to name a specific person or persons as **beneficiary**.

Quiz: Part 3 • Chapter 5

Based on your study of this lesson, please choose the best answer.

1 For assessment purposes, the Department of Health uses real property, including your woodland and principle residence, in the calculation of net assets. ☐ **True** ☐ **False**

2 Unused amounts of charitable donations can be carried forward for:

____ **A) three years** ____ **B) seven years** ____ **C) ten years** ____ **D) five years**

3 When a woodland is donated to charity, the deemed proceeds of disposition are always the fair market value of the woodland. ☐ **True** ☐ **False**

4 When a Will is properly prepared and an Executor has been appointed, probate fees are waived under Provincial Statutes. ☐ **True** ☐ **False**

5 percent of the value of a woodland charitably donated may earn credit as a donation.

____ **A) 25%** ____ **B) 50%** ____ **C) 75%** ____ **D) 100%**

6 Probate fees are based on the value of the estate; the higher the value of the estate, the lower the probate fees. ☐ **True** ☐ **False**

(ANSWER ON PAGE 80)

Concluding Comments

Throughout this course we have outlined and discussed income tax and estate planning issues relevant to Nova Scotia woodland owners. As you can see, these issues are very complex, and it was necessary to present the information in a general way.

The income tax rules that deal with the mechanical calculation of income and tax are black and white. But issues such as business income versus **capital gains**, reasonable expectation of profit, the preferred business entity, and the availability of the "enhanced" capital gains deduction require interpretation and judgement.

Income tax considerations are an important part of conducting business in our present economic and regulatory environment. The annual filing of an income tax return is important – but proper income tax planning involves far more. There is often uncertainty and tough calls have to be made. Your professional advisor can assist with this process.

Each individual's situation is unique, and requires a specific estate plan. In complex situations professional help is advisable. As with any tax matter, circumstances change, so even the best of plans should be reviewed and updated on a regular basis.

Glossary

Accrual Accounting: Accounting method that includes accounts receivable in revenues and accounts payable in expenses. The cost of *inventory* on hand at the end of a *fiscal year* is removed from expenses and reported as an asset.

Adjusted Cost Base: The cost of a capital property for income tax purposes. Most commonly, the actual purchase price of a property.

Alternative Minimum Tax: A refundable tax that is levied when a taxpayer has excessive tax shelters.

Arm's Length: Having separate economic interests.

Attribution Rules: Complex rules in the Income Tax Act that are designed to prevent income splitting. That is, they prevent you from having your income taxed in another person's hands.

Beneficiary: A person who is entitled to receive income and/or capital from a trust.

Beneficial Owner: A person who enjoys the possession and benefits of ownership of a property even though its ownership title is in the name of another person. The beneficial owner remains responsible for tax reporting and tax liability.

Canadian Controlled Private Corporation: A corporation that is controlled by persons resident of Canada, and whose shares are not publicly traded.

Capital Cost Allowance: A deduction for the cost of a capital item over time.

Capital Gain (Loss): The excess (or deficiency) of the proceeds of disposition of a capital property over its adjusted cost base and any costs of disposition.

Capital property: Property which, if disposed of, would produce a capital gain or loss. Generally, property that is not inventory.

Cash Basis Accounting: Accounting method where you only report revenues actually received and expenses actually paid in the year to determine income. The cost of *inventory* on hand at the end of the year is generally included in expense.

Clawback: A term used to mean the repayment of social benefits such as Employment Insurance and Old Age Security. This repayment occurs when a taxpayer's net income exceeds certain limits.

Commercial Woodland: A woodland operated by a taxpayer as a business with a reasonable expectation of profit.

Crystallization: A transaction that triggers a capital gain, which can be sheltered from tax by the capital gains deduction. Generally done with the shares of a corporation, it builds the capital gains deduction into the adjusted cost base of the property. This complex manoeuvre is best handled with professional tax advice.

Depreciable Property: Capital property, such as a building or equipment, which has a limited life. Depreciable property is expensed, for tax purposes, over a number of years, via capital cost allowance.

Disposition: Disposing of property, either by selling or giving it away.

Estate Freeze: A transaction that creates two separate interests in an appreciating asset. One interest equals the current value of the asset but becomes a fixed amount. The second interest has little current value but will increase in value as the asset increase in value.

Executor: The legal representative of a deceased person. The person who manages the estate of a deceased person.

Fair Market Value: The value, in terms of money, that an asset would bring in an open and unrestricted market. The price you would expect to receive on the sale of an asset.

Farm Property: Property (may include land, equipment or buildings) used in the business of farming. Also includes an interest in a family farm partnership and shares of a family farm corporation.

Fiscal year: A 12 month period over which annual accounts and taxes are calculated.

Intestate: Without a Will.

Inventory: Property or other assets that are held for sale in the normal course of business.

Marginal Tax Rate: The tax rate applicable on the last dollar of income.

Mandatory Inventory Adjustment: If there is a loss, the costs of items purchased for sale during the year are added back, up to the point where there is no loss, or in other words income is nil.

Matrimonial Property Act: A Nova Scotia Statute that governs the distribution of matrimonial property if a marriage breaks down.

Median Rule: A method of calculating the adjusted cost base of a property owned on V-Day. The adjusted cost base is the middle amount among the cost, the V-Day value, and the proceeds of disposition.

Prescribed: Specifically determined by the tax rules.

Proceeds of Disposition: The value, for tax purposes, of consideration (payment) received for the disposition of a capital property. There are a number of provisions in the Income Tax Act that deem (or assume) proceeds to be a certain amount, typically either *fair market value,* or the adjusted cost base.

Qualified Farm Property: Land or property (may include buildings or equipment) used by the taxpayer, a spouse, or their children in the business of farming; an interest in a family farm partnership; or shares of a family farm corporation. This property must be held for at least two years.

Qualified Small Business Corporation Shares: Shares of a small business corporation that have been held for at least two years.

Real Property: Land and buildings; real estate.

Recaptured Depreciation: An amount included in income when too much depreciation has been deducted on a given class of property. This occurs when an asset is sold for more than the *undepreciated capital cost.*

Remote Work Location: A work location is considered remote when it is 80 kilometres or more from the nearest established community with a population of at least 1,000 people.

Settlor: The person who creates a trust by transferring property to a trustee under the terms of a trust agreement.

Small Business Corporation: A Canadian controlled private corporation, all or substantially all of the assets of which are primarily used in an active business carried on in Canada.

Special Work Site: an area where temporary duties are performed by an employee who keeps a self-contained domestic establishment at another location as his or her principal place of residence. Because of the distance between the two areas, the employee is not expected to return daily from the work site to his or her principal place of residence.

Spousal Trust: A trust where, during the spouse's lifetime, only the spouse of the deceased person may receive any income or capital from the trust.

Sundry Income: Miscellaneous or "other" income, usually incidental to the main source of revenue.

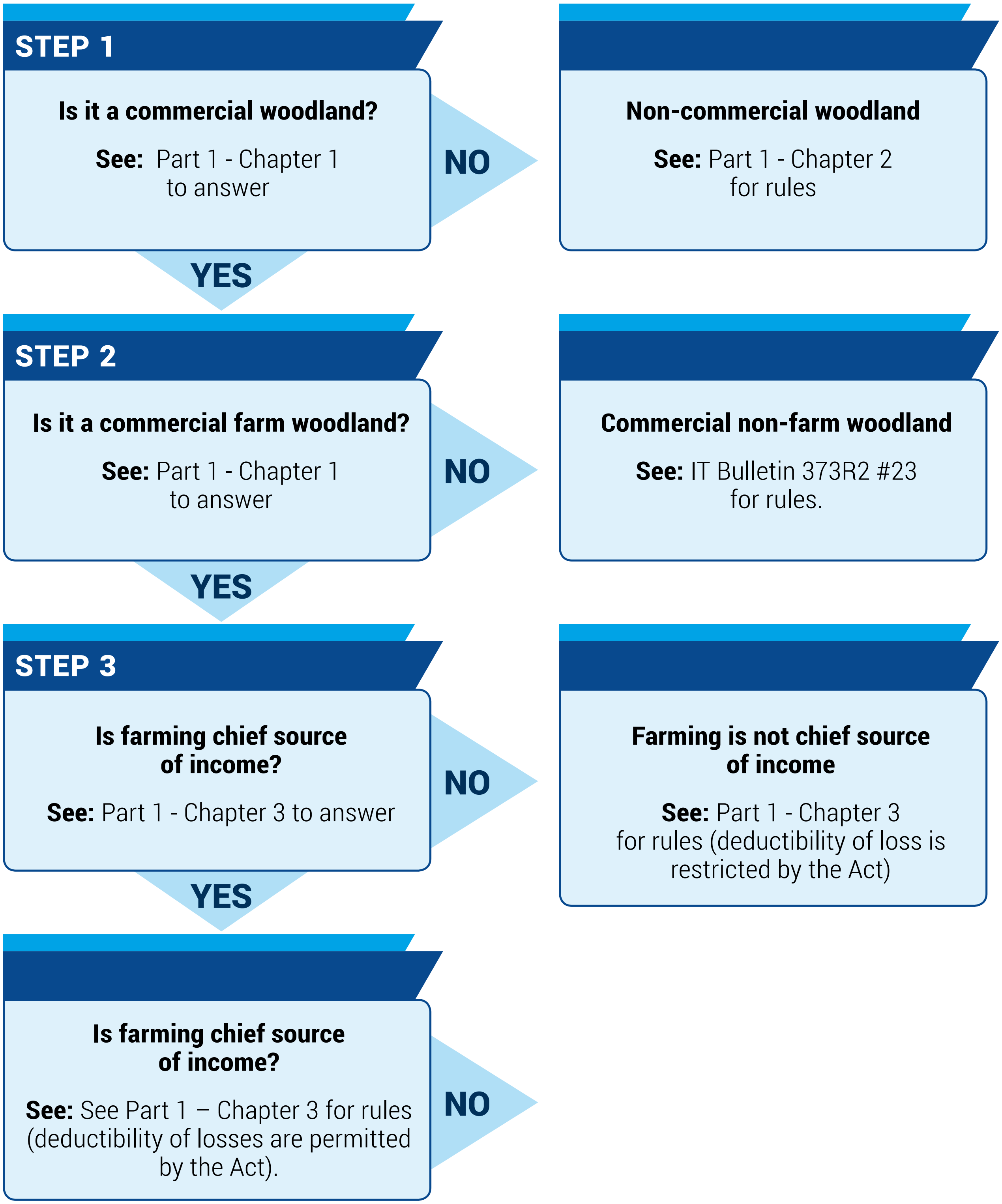
Taxable Capital Gain: One-half of a capital gain realized after October 18, 2000; two-thirds between February 27 and October 17, 2000; and three-quarters before February 27, 2000.

Trustee: A person who holds property for another person.

Undepreciated Capital Cost: The remaining cost of depreciable property that has not yet been deducted.

Valuation Day (V-Day): December 31, 1971 (December 22, 1971 for publically traded securities). The day before capital gains first became taxable in Canada. Capital gains accrued up until that date are not taxed.

Appendix 1: Decision Tree for Nature of Business and Income



Appendix 2: Losses

Business Losses

Tax Year Loss Occurred	Carryback	Carryforward
Before 2003	3 years	7 years
After March 22, 2004	3 years	10 years
After 2005	3 years	20 years

Farm Losses

Tax Year Loss Occurred	Carryback	Carryforward
Before 2006	3 years	10 years
After 2005	3 years	20 years

Appendix 3: 2015 N.S. Marginal Tax Rates[1]

Personal Taxable Income	Tax Rate (%)
On first $11,138	0.00
On $11,139 to $11,894	15.00
On $11,894 to $15,000	23.79
On $15,001 to $21,000	28.79
On $21,001 to $29,590	23.79
On $29,591 to $44,701	29.95
On $44,702 to $59,180	36.95
On $59,181 to $89,401	38.67
On $89,402 to $93,000	42.67
On $93,001 to $138,586	43.50
On $138,587 to $150,000	46.50
On amounts over $150,001	50.00

Corporate Taxable Income	Tax Rate (%)[2]
On first $350,000	14.00
On $350,001 to $500,000	27.00
On excess over $500,000	31.00

1. Effective rates may vary somewhat depending on availability of the "supplementary personal credit" and the surtax reduction. The tax rates reflect actual figures for 2015. Personal tax rates only take into account the basic tax credit.
2. Rates are for active business income only and assume companies with less than $10 million in assets.

Appendix 4: Record Keeping System

Cashbook Accounting Example

Cash Receipts/Bank Deposits

DATE	DESCRIPTION	BANK AMOUNT	SALES/ REVENUE	HST COLLECTED	MISC INCOME	LOANS RECEIVED	...	OTHER RECEIPTS
Jan-12	LOGS TO XYZ LUMBER MILL LTD	7,910.00	7,000.00	910.00				
Jan-21	SOLD LOGGING TRUCK TO ABC CO	12,712.50		1,462.50				11,250.00
Jan-27	INCREASE IN BANK LOAN	5,000.00				5,000.00		
	MONTHLY TOTAL	25,622.50	7,000.00	2,372.50	-	5,000.00		11,250.00

Cash Disbursement/Bank Withdrawals

DATE	DESCRIPTION	CHQ #	BANK AMOUNT	HST PAID	WAGES & BENEFITS	REPAIRS & MAINT	INTEREST EXPENSE	PHONE	LOAN PAYMENTS	OTHER
Jan-04	BANK LOAN PAYMENT		2,500.00						2,500.00	
Jan-10	DEF GARAGE - TRUCK REPAIRS	1001	884.10	101.71		782.39				
Jan-14	EMPLOYEE WAGES	1002	826.00		826.00					
Jan-15	RECEIVER GENERAL - RE DECEMBER	1003	415.00		415.00					
Jan-20	BELL ALIANT	1004	104.67	12.04				92.63		
Jan-27	GHI LTD - NEW LOGGING TRUCK	1005	33,900.00	3,900.00						30,000.00
Jan-28	EMPLOYEE WAGES	1006	826.00		826.00					
Jan-31	BANK INTEREST		322.46				322.46			
MONTHLY TOTALS			39,778.23	4,013.75	2,067.00	782.39	322.46	92.63	2,500.00	30,000.00

Appendix 5: End Notes Referred to in Text, Tax Guides, Interpretation Bulletins and Forms

End Notes

1. Income Tax Act, subsection 248(1) - Definitions
2. Interpretation Bulletin IT-373R2 - Woodlands, paragraph 14 – Meaning of "Farming"
3. CRA Guide T4003, Farming Income
4. Interpretation Bulletin IT-373R2 - Woodlands, paragraph 12 – Capital Transaction
5. The Queen v. Larsen, 99 DTC 5757
6. CRA Guide RC-4409 – Keeping Records, Methods of keeping records
7. CRA Guide RC-4409 – Keeping Records, Requirements for record
8. CRA Guide RC-4409 – Keeping Records, What additional records do corporations have to keep
9. Income Tax Act, paragraph 12(1)(x) – Income inclusions: Inducements, reimbursements, etc.
10. Income Tax Act, subsections 13(7.1) – Deemed capital cost
11. CRA Guide RC-4408 – Farming Income and the AgriStability and AgriInvest Programs Harmonized Guide, Section 5 – Expenses
12. Income Tax Interpretation Bulletin 501 – Capital Costs Allowance – Logging Assets – Roads
13. Interpretation Bulletin IT-373R2 – Woodlands, paragraph 16 – Income Tax Rules
14. Income Tax Act, regulations section 7400 – Prescribed tax treaty provisions and election
15. Income Tax Act, subsection 73(3)
16. Interpretation Bulletin IT-349R3 – Intergenerational Transfers of Farm Property on Death, paragraphs 1 - 5
17. Interpretation Bulletin IT-373R2 – Woodlands, paragraph 18 – Use and Profit Tests

Tax Guides

The CRA publishes "Tax Guides" and "Interpretation Bulletins" to provide information to assist taxpayers with tax compliance requirements as well as document their position with respect to technical matters. These documents can be found on CRA's website at **www.cra-arc.gc.ca**. A sample of publications that may be of interest to woodland owners follows:

2013 General Tax Guide
2013 Business and Professional Income Tax Guide
2013 Employers Guide to Payroll Deductions
2013 RRSP's and Other Registered Plans for Retirement
2013 Farming Income Tax Guide

TAX GUIDES AND INTERPRETATION BULLETINS (Cont'd)

2013 Employers Guide to Payroll Deductions
2013 Employers Guide to Payroll Deductions - Taxable Benefits
2013 T5 Guide – Return of Investment Income
2013 Corporation Income Tax Guide
2013 Corporation Instalment Guide
2013 Capital Gains Tax Guide
2013 Farming Income and the AgriStability and AgriInvest Programs Guide
2013 Preparing Returns for Deceased Persons

Interpretation Bulletins

IT-79R3	Capital cost allowance - Buildings or other structures
IT-128R	Capital cost allowance - Depreciable property
IT-218R	Profit, capital gains and losses from the sale of real estate, including farmland and inherited land and conversion of real estate from capital property to inventory and vice versa
IT-220R2	Capital cost allowance - Proceeds of disposition of depreciable property
IT-232R3	Losses – Their Deductibility in the Loss Year or in Other Years
IT-234	Income of deceased persons - Farm crops
IT-268R4	Inter-vivos transfer of farm property to a child
IT-285R2	Capital cost allowance - General comments
IT-287R2	Sale of inventory
IT-322R	Farm losses
IT-349R3	Intergenerational transfers of farm property on death
IT-373R2	Woodlots (woodlands)

IT-425	Miscellaneous farm income
IT-433R	Farming or fishing - Use of cash method
IT-478R2	Capital cost allowance - Recapture or terminal loss
IT-485	Cost of cleaning or levelling land
IT-501	Capital cost allowance - Logging assets
IT-526	Farming - Cash method inventory adjustments

FORMS

Forms that would be commonly filed by a woodland owner carrying on business as a proprietor or partner are:

T1 General	Federal and Nova Scotia Individual Income Tax Return
Schedule 1	Detailed Tax Calculation
Schedule 2	Amounts Transferred From Your Spouse
Schedule 3	Capital Gains or Losses
Schedule 4	Statement of Investment Income
T2125	Statement of Business Income and Expenses
T2038	Investment Tax Credit - Individuals
T2042	Statement of Farming Income
CCA	Summary of Capital Cost Allowance
Donations	Charitable Donations

Forms that would be commonly filed by corporations (in addition to financial statements for the business) include:

T2	Corporation Income Tax Return
S1	Reconciliation of Net Income per Financial Statements with Net Income for Federal Income Tax Purposes
S2	Charitable Donations
S4	Continuity of Losses Carried Forward
S8	Summary of Capital Cost Allowance
S31	Investment Tax Credit - Corporation

In addition, employers would be required to file:

T4 Summary	Summary of Remuneration Paid
T4 Supplementary	Statement of Remuneration Paid.

Appendix 6: Exercise And Quiz Answers

Part 1: Income Tax Guide

Exercise 1

Yes, Jennifer's woodland qualifies as a commercial farm business and is considered a commercial woodland since she has a management plan and is planting, thinning, etc. instead of just harvesting.

Chapter 1 Quiz:

1) **T** 2) **T** 3) **T** 4) **F** 5) **T** 6) **F** 7) **T** 8) **T** 9) **F** 10) **F** 11) **T** 12) **T**

Exercise 2

Proceeds of disposition = $60,000 - $1,700	$58,300
Adjusted cost base = $25,000 - $10,000 bare land value	15,000
Capital gain	$43,300
Taxable capital gain	$21,650

Chapter 2 Quiz:

1) **F** 2) **T** 3) **F** 4) **T** 5) **d** 6.) **c** 7) **T** 8) **b**

Exercise 3

A) ATV deduction would be: $9,000 x 75% business use = $6,750

$6,750 x 30% x ½ (first year)	= $1,013
Wood splitter deduction would be $2,000 x 20% x ½	200
	$1,213

B) Depletion allowance = cords harvests/cords documented by cruise x (woodland cost – bare land value)

= 24 cords/2,400 cords x (45,000 – 15,000) = 0.01 x 30,000 = $300

Exercise 4

($2,500 + 1/2(25,000 – 2,500) = $13,750

Exercise 5

Capital Cost Allowance: \$200,000 x 20% x ½ (year of purchase) =	\$20,000
Marginal Rate	30%
	\$ 6,000
Investment Tax Credit: \$36,000 x 10%	20,000
	\$ 26,000

Chapter #3 Quiz:

1) **F** 2) **T** 3) **F** 4) **F** 5) **T** 6) **T** 7) **T** 8) **T** 9) **T** 10) **b**, **d**, **f** 11) **b** 12) **a** 13) **F** 14) **d**

Chapter #4 Quiz:

1) **F** 2) **T** 3) **F** 4) **T** 5) **T** 6) **F** 7) **T** 8) **F** 9) **F** 10) **F** 11) **F**

Part 2: Forest Management Planning

Quiz 1:

1) **T** 2) **T** 3) **F** 4) **T**

Part 3: Estate Planning Guide

Chapter #1 Quiz:

1) **F** 2) **T** 3) **F** 4) **T** 5) **T** 6) **a - b** 7) **c**

Chapter #2 & #3 Quiz:

1) **T** 2) **F** 3) **F** 4) **T** 5) **F** 6) **T** 7) **F** 8) **T** 9) **b** 10) **a**

Exercise 6

A) When you die scenario: child's cost of the property would be deemed to be \$15,000 (this assumes the woodland meets the criteria for qualified farm property, otherwise it would be deemed to be disposed of at fair market value at the time of death).

Give it to her now scenario: Deemed proceeds of disposition would be \$15,000 (again, assumed qualified farm property). There would be no gain or loss and a cost of \$15,000 for her daughter.

Answer is no difference.

B) **Yes**, in this case it would be better for Ashley to sell the woodlot to her at a price between $15,000 and $30,000. A selling price of $30,000 would result in a capital gain as follows:

($30,000 - $15,000) x 1/2 = $7,500. This would be sheltered by the capital gains deduction. The cost of the property to the daughter would be $30,000, reducing her taxes when she disposes of the property in the future.

Chapter #4 Quiz:

1) **b** 2) **T** 3) **F** 4) **F** 5) **F** 6) **T**

Exercise 7

Proceeds of disposition	$ 25,000
Adjusted cost base	16,000
Capital gain	$ 9,000
Taxable capital gain (50%)	4,500
Tax on gain (at 40%)	$ 1,800
Tax credit for charitable donation:	
On the first $200 at 24%	$ 48
On the balance ($25,000 - $200) at 50%	12,400
	$ 12,448
Tax savings ($12,448 - $1,800)	$ 10,648

Chapter #5 Quiz:

1) **F** 2) **d** 3) **T** 4) **F** 5) **d** 6) **F**

NOVA SCOTIA

woodlot.novascotia.ca