NO.: **IT-373R2 (Consolidated)** DATE: See *Bulletin Revisions* section

SUBJECT: INCOME TAX ACT
Woodlots

REFERENCE: Section 9 (also subparagraph 40(2)(*g*)(iii); paragraphs 12(1)(*g*), 18(1)(*a*) and 18(1)(*h*); subsections 18(2), 28(1), 70(9), 70(9.1), 70(9.2), 70(9.3), 73(3) and 248(1); and sections 31, 43, 46, 54, 67, 110.6 and 111)

Latest Revisions – ¶s 10, 12, 17 and 18

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Contents

Application

This bulletin is a consolidation of the following:

- IT-373R2 dated July 16, 1999; and
- subsequent amendments thereto.

For further particulars, see the "Bulletin Revisions" section near the end of this bulletin.

Summary

This bulletin deals with some of the issues in the determination of taxable income, for income tax purposes, of owners and operators of woodlots, **including woodlots operated as farms**. The bulletin is not directed at the operation of logging, lumbering, papermaking or other similar businesses, even if they are sometimes called "tree farms" or they engage in reforestation. In addition, it does not address hunting, recreation, mushroom picking or wildflower operations.

A list of factors to consider in determining whether a woodlot is operated with a reasonable expectation of profit is provided. Both woodlots operated as farms and non-farm woodlots are discussed and the bulletin identifies some of the income tax rules that apply to each type of woodlot.

This bulletin is intended to assist taxpayers in determining the main income tax rules that apply to their woodlot operations. It is not intended to be a comprehensive tax guide.

Discussion and Interpretation

INTRODUCTION

Meaning of "Woodlot"

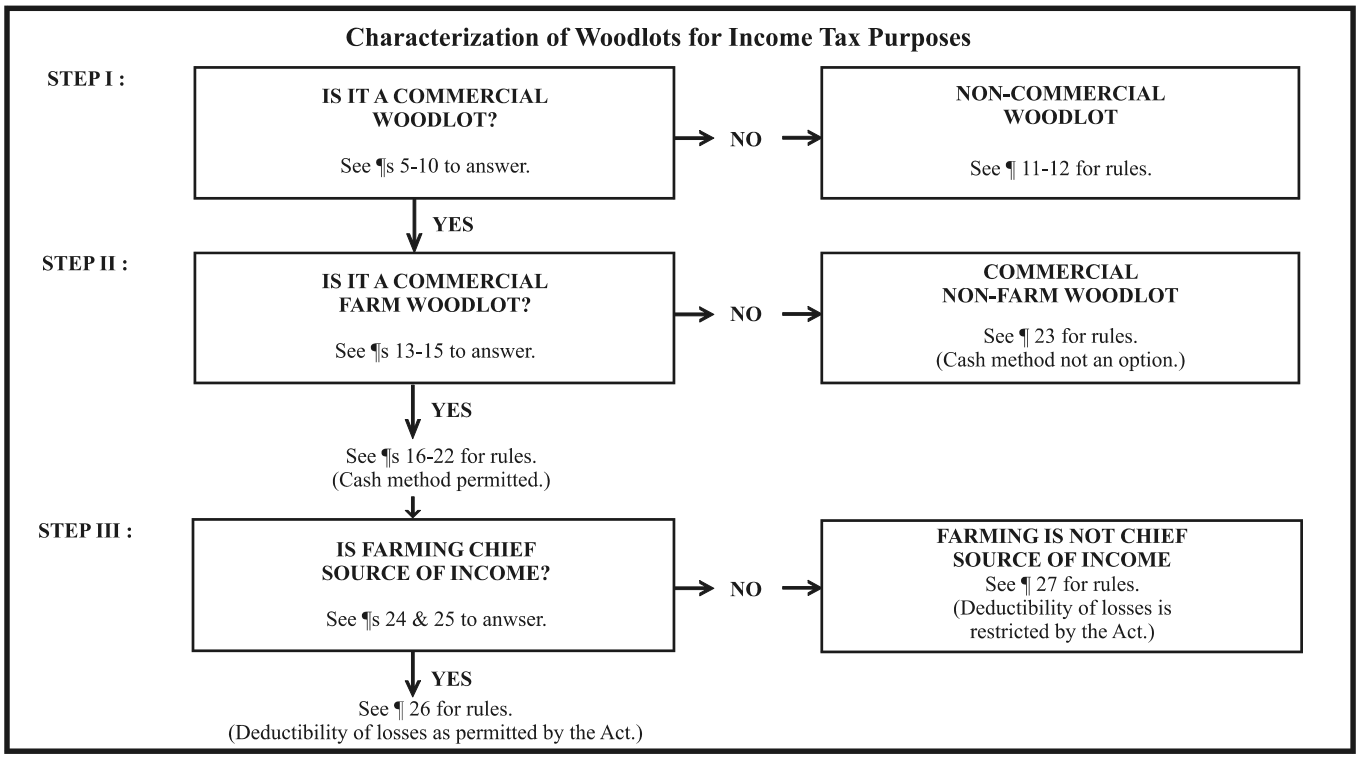
¶ 1. The word **"woodlot"** is neither used nor defined in the *Income Tax Act*. In this bulletin, "woodlot" is used in a broad sense to mean land covered with trees. A woodlot includes treed land held primarily as a source of fuel, posts, logs or trees, **whether the trees are grown with or without human intervention**. The term also includes treed land that is part of a cottage property and a farmer's wooded land.

In this bulletin, where a taxpayer operates a woodlot as a business with a reasonable expectation of profit, it is referred to as a **commercial woodlot**. The term "**commercial woodlot**" is also used where there is an adventure in the nature of trade in connection with a woodlot (see ¶ 9), and where an amount based on the use of, or production from, a woodlot (see ¶ 10) is received. If a woodlot is not operated by a taxpayer as a commercial woodlot, it is referred to as a **non-commercial woodlot**.

Taxation of Woodlots

¶ 2. There is no specific set of income tax rules that applies solely to woodlot owners or woodlot operations. The general rules for the computation of income and taxable income apply.

The following is an illustration of three main issues that must be resolved in order to determine the income tax rules that will apply to a particular woodlot



¶ 3. Whether a taxpayer operates a woodlot as a commercial woodlot or a non-commercial woodlot, several specific provisions in the income tax legislation, court cases and general accounting rules restrict the deductibility of expenses. In particular, there is a general purpose test in paragraph 18(1)(*a*), which provides that expenses are only deductible to the extent that they are made for the purpose of earning income from business or property. In addition, paragraph 18(1)(*h*) generally precludes the deduction of personal and living expenses and section 67 provides that only reasonable expenses may be deducted.

Steps to Follow to Determine Which Tax Rules Apply

¶ 4. The following steps should be followed to determine how a taxpayer's income from a particular woodlot will be taxed:

Step I: Is the woodlot considered a commercial or a non-commercial woodlot?

See ¶s 5 to 7 to determine if a taxpayer operates a woodlot with a reasonable expectation of profit.

- If the taxpayer operates the woodlot as a business with a **reasonable expectation of profit**, it is a commercial woodlot. See Step II.
- If there is an **adventure in the nature of trade** (for example, where the activities undertaken to sell trees or the right to cut trees are similar to the activities that would be followed by a taxpayer in the business of selling trees or the right to cut trees), the woodlot will be considered a commercial woodlot. See ¶s 8 and 9 and Step II.
- If an amount received for the sale of trees or the right to cut trees is based on the use of, or production from, the woodlot (i.e., if it is a paragraph **12(1)(*g*) amount**), the woodlot will be considered a commercial woodlot. See ¶s 8 and 10 and Step II.
- If the woodlot is not a commercial woodlot, it is considered a non-commercial, or hobby, woodlot. See ¶s 11 and 12.

Step II: Is commercial woodlot operated as a farm?

See ¶s 13 and 14 to determine whether a commercial woodlot is operated as a farm (a "commercial farm woodlot") or whether the commercial woodlot is not operated as a farm (a "commercial non-farm woodlot"). Christmas tree growers should also see ¶ 15.

- If the woodlot is a commercial farm woodlot, see ¶s 16 to 22 and Step III.
- If the commercial woodlot is not operated as a farm, see ¶ 23.

Step III: Is farming the chief source of income?

See ¶s 24 and 25 to determine whether farming is the chief source of income.

- If farming is the chief source of income, see ¶ 26.
- If farming is not the chief source of income, see ¶ 27.

STEP I: IS THE WOODLOT CONSIDERED A COMMERCIAL WOODLOT OR A NON-COMMERCIAL WOODLOT?

Commercial Woodlot

Reasonable expectation of profit

¶ 5. Whether or not a taxpayer reasonably expects to profit from the taxpayer's woodlot operation is an objective determination to be made after a review of all the facts. The main focus is the activities of the **taxpayer** and the expectation that the taxpayer will have a profit. The relevant factors to be considered will differ with the nature and extent of the activity or undertaking of the sole proprietorship (an individual), the corporation, the partnership, or the trust.

¶ 6. No single factor described in ¶ 7 will determine conclusively whether or not an activity is carried on by a taxpayer with a reasonable expectation of profit. Although all relevant criteria are considered in making a determination, depending upon the situation, certain factors may be more important than others. The non-existence of any one particular factor will not necessarily preclude the taxpayer's activities in respect of a woodlot from qualifying as a commercial enterprise.

¶ 7. Factors which the Department will consider in determining whether or not a taxpayer can reasonably expect to earn a profit from a woodlot include:

(a) The extent of planning for the woodlot operation – for example, whether the taxpayer has a forestry management plan or a similar resource plan with a description of the resource and schedule of harvesting and good forestry practices to be undertaken to sustainably manage the output of timber and other products; whether the taxpayer has a financial plan that projects the taxpayer's costs, revenues, and profits; and whether good records for the implementation of the plans are maintained.

(b) The effort the taxpayer has made to personally acquire or to hire the expertise necessary to successfully implement the plans in (a).

(c) The implementing and updating of the plans in (a).

(d) Time spent on the woodlot operation in comparison to that spent in employment or other income-earning activity. – If the taxpayer spends most of the time attending to the woodlot, there is a strong presumption that the taxpayer is carrying on a business, particularly if the taxpayer has forestry background or experience. Of course, the time spent in running the business must be adequate to properly implement the forestry management, financial and other plans for the woodlot.

(e) The extent of activity in relation to that of woodlot operations of a comparable nature and size in the same or similar locality. – One test is the size of the property used as a woodlot. For example, if the property is,

considering the type of trees and the geographic location, much too small to give a reasonable expectation of profit, the presumption is that the property is being held for personal use or enjoyment of the taxpayer.

(f) Qualification of the taxpayer for some type of government assistance. – In a particular assistance program, it may be useful to determine whether the granting authority requires or presumes the recipient to be in the business of farming, forestry or otherwise operating a commercial woodlot.

(g) The historical record of annual revenue and profits or losses relevant to the operation of the woodlot, and the growth of the gross revenue and profits over time. – In applying this factor, external influences such as weather conditions (e.g., wind storm, prolonged drought, severe hail, frost or flood) and fire, insects or disease and economic conditions which may affect the trees will be taken into consideration. When there is no, or a very small amount of, gross income for several years, there is a presumption that the operation was conducted by a taxpayer who cannot reasonably expect to profit from the woodlot. This presumption may be rebutted depending upon evidence such as the resource management or financial plans of the operation and the other factors elsewhere in this paragraph.

It is recognised that the nature of a woodlot is such that a considerable period of time may pass before the taxpayer may receive revenue from the woodlot, since many varieties of trees require a considerable amount of time in which to grow before they can be harvested. The reasonable expectation of profit test may recognize that it takes time to create a marketable product; however, it is the woodlot business itself, whether the business is operated as a sole proprietorship, a corporation, a partnership or a trust, which must be expected to generate a profit for the taxpayer.

(h) The type of expenditures claimed and their relevance to the endeavours.

(i) The owner or operator's farming or forestry qualifications, as evidenced by education and experience.

(j) The membership in any association of woodlot owners or other relevant professional or business organizations.

Other commercial woodlots

General

¶ 8. A sale of timber is subject to tax on income, not capital, account as a **commercial woodlot** if the transaction is an **adventure in the nature of trade** (see ¶ 9) or if a **payment was based on the use of or production from the property** (see ¶ 10).

Adventure in the nature of trade

¶ 9. Income received from an adventure or concern in the nature of trade is considered to be business income under the Act. The primary consideration in determining whether an activity, such as the sale of timber, is an adventure or concern in the nature of trade is whether the taxpayer's actions with regard to the property in question were essentially what would be expected of a dealer in the same property. See the current version of IT-459, *Adventure or Concern in the Nature of Trade*, for more details on how to determine whether an activity or undertaking is an adventure or concern in the nature of trade.

Payments based on production or use – paragraph 12(1)(*g*)

¶ 10. Where an amount (except an instalment of the sale price of agricultural land) that was dependent on the use of or production from property is received, it may be considered as income from business or property under paragraph 12(1)(*g*). For example, where a woodlot owner or operator grants a person a continuing right to cut and take timber over a period of time and the consideration that the woodlot owner or operator receives is based on the volume of timber taken, the amount received is taxable under paragraph 12(1)(*g*). For further information about the application of paragraph 12(1)(*g*), refer to the current version of IT-462, *Payments Based on Production or Use*.

Non-Commercial Woodlot

¶ 11. Where a woodlot is a non-commercial woodlot, and money or other valuable consideration is received for the sale of timber or the right to cut timber, the sale proceeds are subject to tax on capital account, generally as a disposition of "personal-use property." Generally, a loss on the sale of personal-use property is not deductible. Where the proceeds from a sale of timber exceed $1,000, the sale may result in a capital gain, three-quarters of which is taxable. For further information about capital gains and the determination of the adjusted cost base of a property, see the current version of the guide called *Capital Gains* and the current versions of IT-332, *Personal-Use Property*, and IT-456, *Capital Property – Some Adjustments to Cost Base*.

Capital Transaction

¶ 12. Where a person who is **not** operating a woodlot as a commercial enterprise as described in STEP I above receives an amount for allowing someone to cut and remove timber from his or her woodlot, the sale will be taxable on capital account if **all** the following conditions are met:

(a) the land was not acquired with the specific intent of selling timber or land;

(b) 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);

(c) 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

(d) the timber is to be removed over a short period of time (such as several months or such shorter period of time that, given the particular set of circumstances, would be reasonable to consider as a short period).

STEP II: IS COMMERCIAL WOODLOT OPERATED AS A FARM?

Meaning of "Farming"

General

¶ 13. For purposes of the Act, the word "farming" is defined in subsection 248(1) to include a number of activities. Generally, farming contemplates the raising and harvesting of various animals or plants in a controlled environment. It is defined to include 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. However, "farming" does not include an office or employment with a taxpayer engaged in the business of farming. This list is not exhaustive and it has been decided by the courts that the word "farming" can include growing trees. In certain factual circumstances, it is considered that farming includes the operation of nurseries and greenhouses.

¶ 14. Whether a woodlot constitutes a farming operation or a logging business or another commercial operation is a question of fact. If the main focus of a business conducted with a reasonable expectation of profit (a **commercial woodlot**) is not lumbering or logging, but is planting, nurturing and harvesting trees pursuant to a forestry management or other similar resource plan and significant attention is paid to manage the growth, health, quality and composition of the stands, it is generally considered a farming business (a **commercial farm woodlot**). If the main focus of a business is logging (a commercial non-farm woodlot), and is not growing, nurturing and harvesting trees, the fact that reforestation activities are carried out would not transform that business into a farming operation.

Christmas tree growers

¶ 15. The planting, caring for and harvesting of Christmas trees by a taxpayer who grows and nurtures evergreens to sell as Christmas trees—or who buys land so planted to tend and harvest the trees—is regarded as a farming business regardless of whether the taxpayer is carrying on any other type of farming operation, provided the operations are carried on with a reasonable expectation of profit. Where a taxpayer relies on naturally seeded regeneration, whether a particular business will be a farming business will depend upon the focus of the business and how the trees are nurtured.

Christmas tree growers should follow the same steps as other woodlot owners and operators (described in ¶ 4) to determine the tax rules that will apply.

A stand of Christmas trees is not viewed as a timber limit since the output is trees, not timber or similar products, and the capital cost[1] allowance in Schedule VI of the *Income Tax Regulation*s is not applicable.

Commercial Farm Woodlot

Income tax rules

¶ 16. Where a taxpayer is operating a commercial woodlot as a farm, the following rules will—subject to the provisions of section 31 (which may restrict the deductibility of losses), the general rules described in ¶ 3, and certain specific rules (such as subsection 18(2))—apply:

(a) The taxpayer is entitled to report the income from that operation in accordance with the cash method if an election is made under section 28. The taxpayer may instead choose to report this income in accordance with the accrual method. For further information, refer to the current version of IT-433, *Farming or Fishing – Use of Cash Method*, and the guide called *Farming Income*.

(b) The costs of purchasing and planting the trees are deductible in the year if the taxpayer is reporting the income from the operation under the cash method.

The optional and mandatory inventory adjustments under paragraphs 28(1)(*b*) and (*c*), respectively, apply to a taxpayer using the cash method to compute income from a farming business (see the current version of IT-526, *Farming – Cash Method Inventory Adjustments*). Where a taxpayer buys land that is already planted with trees, the trees would not generally be inventory. However, where trees are purchased as inventory separately from the land on which they stand, the cost of purchasing the trees is added to inventory.

Seeds or seedlings that have been planted are not considered purchased inventory on hand at the end of the year for purposes of the mandatory inventory adjustment.

(c) Generally, under the cash method, recurring expenses directly related to the commercial activity are deductible in the year in which they are paid. Whether a particular planting, pruning, thinning, fertilizing, cultivating, and property tax expenditure is a recurring expense will depend on the particular circumstances. If land is not used in the business in a particular year, subsection 18(2) may restrict the deductibility of interest and property taxes.

(d) Capital cost allowance may be available in respect of the cost to the taxpayer of the woodlot. For information on this topic, see the current version of IT-481, *Timber Resource Property and Timber Limits.*

[1] Corrected on January 3, 2003

(e) Certain assets used in a woodlot (roads, drainage systems, etc.) may be written off as current expenses or must be depreciated in accordance with the Act and the Regulations. The appropriate income tax treatment is described in the current version of IT-501, *Capital Cost Allowance – Logging Assets*.

For further information, including information about changing the system of accounting for a farm operation, see the guide called *Farming Income*. See the current version of IT-128, *Capital Cost Allowance – Depreciable Property*, for guidelines in determining whether an expenditure is on capital account or may be deducted as a current expense.

Capital cost allowance is only available if an asset was acquired for the purpose of gaining or producing income.

Capital gains deduction for commercial farm

Real property requirement

¶ 17. Subsection 110.6(2) provides for a $500,000 capital gains deduction for farmers. In order for a transaction to be eligible for this enhanced deduction for an individual farmer who is a resident of Canada, there must be a disposition of a "qualified farm property," which is defined in subsection 110.6(1). A commercial farm woodlot, as described in this bulletin, may be a qualified farm property for the purpose of this definition if it is a "real property" at law.

For example, the capital gains deduction may be available where an individual sells a fee simple in treed land, since it is a real property. However, since the capital gains deduction is not available when "personal property" is sold, the capital gains deduction cannot be claimed on the sale of timber, or on the sale of a licence to cut and take timber. Where an individual sells a property that is a right to cut and take timber, which is a real property (a *profit à prendre),* the capital gains exemption will not be available where the disposition was taxed on income account under paragraph 12(1)(*g*). (See *Berkheiser* v. *Berkheiser and Glaister*, [1957] S.C.R. 387; *Laidlaw* v. *Vaughan Rhys* [1911] 44 S.C.R. 458; *Lisafield* v. *M.N.R.*, 91 DTC 1197, and *Gillies Bros. Ltd.* v. *The King*, (1947) 2 D.L.R. 769, for a discussion of the distinction between a licence and a *profit à prendre*.) Although it is not determinative, one indication that a property is a real property is that it was transferred under the land registry or land titles system of the province in which the land is situated and not simply by contract.

The capital gains deduction is not available on a disposition of a "timber resource property," which is defined in subsection 13(21) and explained in the current version of IT-481, *Timber Resource Property and Timber Limits*, or on a disposition of treed land to the extent that the trees on the land are inventory since dispositions of timber resource properties and inventory are taxable on income, not capital, account.

Use and profits tests

¶ 18. In addition to the requirement that the property disposed of must be a real property, certain other requirements, such as a use test and a profits test, must be satisfied to qualify for this capital gains deduction. For property acquired on or before June 17, 1987, real property may qualify if the property has been used principally in the course of carrying on the business of farming in Canada by any of the taxpayers described in subparagraphs 110.6(1)(*a*)(i) to (v) of the definition of "qualified farm property" in the year of its disposition, or if it was used principally in the business of farming for at least 5 years during which it was owned by any of the taxpayers described in subparagraphs 110.6(1)(*a*)(i) to (iii) and (v).

When reference is made to an asset being used "principally" in the business of farming, the asset will meet this test where more than 50% of the asset's use is in the business of farming. Whether or not particular assets are "used principally in the business of farming" is a question of fact to be determined on a property by property basis (i.e., this test would have to be satisfied for each legal parcel of land). Where paragraph 12(1)(*g*) did not apply, a property that is a right to cut and take trees that is considered a *profit à prendre* may satisfy the use test, provided that either the trees or the treed land had been used by the specified taxpayers for the requisite period of time in carrying on a farming business.

For property acquired after June 17, 1987, a gross revenue test must be satisfied for a particular farm property to be qualified farm property for the purposes of the enhanced capital gains deduction. This gross revenue test must also be satisfied where a capital gains election was filed on the property (and the election was not revoked) and, as a result, the property was deemed to have been reacquired by the elector immediately after February 22, 1994.

General

¶ 19. The filing, in and of itself, of the capital gains election in respect of land on which timber grows will not cause income from subsequent sales of timber to be treated as on capital account.

For further information on the capital gains exemption for farmers, including its application where the farm is held through a corporation or a partnership, refer to the current versions of the guides called *Capital Gains* and *Farming Income*.

Income tax deferral on transfer of commercial farm property

¶ 20. Where a woodlot is operated as a farming business, subsection 73(3) may apply to provide for a deferral of a capital gain and recapture when a parent, while living, transfers—to his or her child (or grandchild or stepchild, etc.) who is a resident of Canada—property used in a farming business by the parent, or by the parent's spouse or child. The property may be land in Canada, depreciable property in Canada of a prescribed class, or eligible capital property of a business carried on in Canada. The transfer may be by way of sale or gift. No *inter vivos* income tax deferral is available on a transfer of property held as inventory.

¶ 21. Similar rollovers are provided by subsections 70(9), 70(9.1), 70(9.2) and 70(9.3) for transfers on the death of a parent to children (or grandchildren or stepchildren, etc.) who operate their parents' woodlot farms.

¶ 22. For further information on intergenerational rollovers of farm property, including their application where the farm is held through a corporation or partnership, refer to the current versions of IT-268, *Inter Vivos Transfer of Farm Property to Child*, and IT-349, *Intergenerational Transfers of Farm Property on Death*.

Commercial Non-Farm Woodlot – Income Tax Rules

¶ 23. Where a commercial woodlot is not operated as a farm, the following rules will—subject to the general rules described in ¶ 3 and specific rules such as subsection 18(2) (which may restrict the deductibility of interest and property taxes)—apply:

(a) Income must be reported using the accrual method. Where a taxpayer buys land that is already planted with trees, the trees would not generally be inventory. However, where trees are purchased as inventory separately from the land on which they stand, the cost of purchasing the trees is added to inventory.

Generally speaking, recurring expenses directly related to the commercial activity are deductible in the year in which they are incurred. Whether a particular planting, thinning, fertilizing or property tax expenditure is a recurring expense will depend on the particular circumstances. If land is not used in a business in a particular year, subsection 18(2) may restrict the deductibility of interest and property taxes.

(b) Capital cost allowance may be available in respect of the cost to the taxpayer of the woodlot. For information, see the current version of IT-481, *Timber Resource Property and Timber Limits.*

(c) Certain assets used in a woodlot (roads, drainage systems, etc.) may be written off as current expenses or must be depreciated in accordance with the Act and the Regulations. The appropriate income tax treatment is described in the current version of IT-501, *Capital Cost Allowance – Logging Assets.*

(d) Section 31, which restricts the deductibility of losses from certain farming businesses, does not apply to non-farm commercial woodlot operations.

(e) The $500,000 capital gains deduction for farm land is not applicable.

(f) The income tax deferral rules for transfers of farm property to children (see ¶s 20, 21 and 22) do not apply.

For further information, see the *Guide for Canadian Small Business* and the guide called *Business and Professional Income*. See the current version of IT-128, *Capital Cost Allowance – Depreciable Property*, for guidelines in determining whether an expenditure is on capital account or may be deducted as a current expense.

Capital cost allowance is only available if an asset was acquired for the purpose of gaining or producing income.

STEP III: IS FARMING THE CHIEF SOURCE OF INCOME?

General

¶ 24. In order to determine whether losses from a commercial farm woodlot are fully deductible, or whether the deductibility of those losses is restricted by section 31, it is necessary to first determine whether the chief source of income is farming. If a commercial farm woodlot is the chief source of income, section 31 does not apply to restrict the deductibility of losses from operating that business. If farming is not the chief source of income, section 31 may restrict the amount of any loss that may be claimed in a year. For more information concerning the calculation and the deductibility of losses, refer to the current versions of IT-232, *Losses – Their Deductibility in the Loss Year or in Other Years*, and IT-322, *Farm Losses*.

¶ 25. In determining the chief source of income, the Courts have considered, in relation to the other sources of income, three criteria, that is, time commitment, capital commitment and expectation of significant profitability (see *The Queen v. Raymond Morrissey*, 89 DTC 5080, [1989] 1 CTC 235, (FCA), and *William Moldowan v. The Queen*, 77 DTC 5213, [1977] CTC 310, (SCC)). A taxpayer may have a farming loss without affecting the status of farming as a chief source of income in the taxation year in which the loss occurs. Accordingly, the test of simply comparing net income from each source as the test for determining the chief source of income in a taxation year is not necessarily conclusive in and by itself. See the current version of IT-322, *Farm Losses*, for more information.

Farming Is Chief Income Source

¶ 26. The losses from a commercial farm woodlot of a taxpayer whose chief source of income is farming or a combination of farming and some other source of income are deductible under the general rules of the Act and deductibility is not restricted by section 31. Such a taxpayer's farming operations may reasonably be expected to provide the bulk of income or the centre of work routine, and are the taxpayer's major preoccupation. The phrase "a combination of farming and some other source of income" means that while the chief source of income is farming there are also subordinate sources of income such as employment, business or property that may be unrelated to the farming operations.

Farming Is Not Chief Income Source

¶ 27. The amount of the farming loss that would otherwise be deductible in a year by a taxpayer who operates a woodlot as a farming business, but whose chief source of income is neither farming nor a combination of farming and some other source of income, is restricted by section 31. Although a

taxpayer may devote the major part of his or her time and effort to a business other than the woodlot or to employment, he or she must operate the woodlot with a reasonable expectation of profit for the losses from operating the woodlot to be deductible to the extent permitted by section 31. Where there is a reasonable expectation of profit, any farming loss that is not deductible in the year by reason of section 31 becomes a "restricted farm loss." It may be carried back three years and forward ten years, but its deduction in a given year is limited to the amount of the taxpayer's income from all farming businesses for the year.