

Tax Alert – Canada

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Supreme Court of Canada allows appeal in *Daishowa-Marubeni International Ltd. v The Queen*, 2013 SCC 29

“In this appeal, the Court is called upon to answer the age-old question: if a tree falls in the forest and you are not around to replant it, how does it affect your taxes?”

Supreme Court of Canada Justice Marshall Rothstein

In a highly-anticipated decision, the Supreme Court of Canada (SCC) has overturned the lower courts' findings that the assumption of reforestation obligations constituted proceeds of disposition to the vendor of timber mill assets. This decision is of particular importance in the context of the purchase and sale of timber, energy and mining properties, where reforestation, reclamation or remediation obligations are often assumed by a purchaser. However, the principles set out by the SCC could also be relevant to other sale agreements that involve the assumption of certain types of obligations by the purchaser.

Facts

Daishowa-Marubeni International Ltd. (Daishowa) sold the assets of its two timber mill divisions to Tolko Industries (Tolko) and Seehta Forest Products Ltd. (Seehta). Each sale agreement included a provision for the assumption by the purchaser of Daishowa's reforestation liabilities. At the time of closing, the current reforestation liability of the Tolko transaction was estimated to be around \$2 million, and the long-term (8- to 14-year) reforestation liability was estimated to be over \$9 million. The amounts in the Seehta transaction were \$560,000 and \$2.4 million, respectively.

Based on input from tax advisors, the purchase price did not specifically include the assumption of the reforestation obligations in both transactions. The purchase agreement simply provided that the purchaser assumed these obligations. The Minister assessed Daishowa by including the amount of the estimated reforestation liability in the calculation of its proceeds of disposition of timber resource properties: \$11,000,000 in the Tolko agreement and \$2,996,380 in the case of Seehta. Daishowa argued that no such amounts should be included in its proceeds of disposition and, in the alternative, if any amount was to be included, that it was entitled to an offsetting deduction from income.

Tax Court of Canada decision

The Tax Court of Canada (TCC), per Justice Campbell J. Miller, noted that the taxpayer had admitted in its pleadings that it received a benefit by the purchaser assuming the reforestation obligations. Given this admission, the TCC concluded that the assumption was part of the consideration paid for the timber assets, notwithstanding that the taxpayer “took great pains to have that element of the deal removed from the definition of purchase price in the agreement.”

The taxpayer argued that the value of this benefit was so uncertain that it would be improper to bring any amount into the proceeds of disposition (citing the decisions in *Northland Pulp and Timber Ltd.*, *Burnco* and *Harysh*). However, the TCC was not prepared to interpret these cases as supporting a general principle that if an amount is uncertain, it is never to be subjected to the tax regime.

That being said, the TCC held that the amount required to be included was a lesser amount than had been assessed by the Minister. After considering a number of factors, Justice Miller concluded that Daishowa should have included the estimated cost of the current reforestation obligations (those that would take place within the 12 months following each sale) plus 20% of the estimated cost of the future obligations.

Federal Court of Appeal decision

Daishowa appealed, and the Crown cross-appealed on the basis that it was not open to the TCC judge to apply a discount factor to arrive at values for the obligations different from those stipulated by the parties in their agreements.

The Federal Court of Appeal’s (FCA) decision was split two to one. The majority allowed the appeal in part and allowed the Crown’s cross-appeal.

Justice Marc Nadon, writing for the majority, found that the TCC judge made no error in finding that, with respect to the Tolko deal, the reforestation liabilities should be included in the proceeds of disposition. The taxpayer had admitted that it received a benefit by virtue of the assumption of the reforestation liabilities. The majority emphasized that the sale price of a property includes any consideration received by a seller from a buyer, including cash, property and the assumption of liabilities.

Dealing with the issue of the valuation of the liabilities, the majority found with respect to the Tolko deal and based on the terms of the purchase and sale agreement, that the parties had attributed a specific and agreed value of \$11 million for the reforestation liability. The FCA rejected Daishowa’s argument and the TCC’s decision that the \$11 million was simply an estimate and not an agreed-upon value. Further, the FCA concluded that subsection 13(21) of the *Income Tax Act* provides that the “proceeds of disposition” of property includes “the sale price of property that has been sold” regardless of whether the liability assumed by the purchaser is absolute or contingent. Thus, the majority found that the TCC judge was wrong to discount the long-term portion of the liability. The agreed-upon value of the assumed liability was \$11 million for the Tolko deal and that amount was to be included in the proceeds of disposition. As a result, the Crown’s cross-appeal was allowed.

The majority determined that with respect to the Seehta deal, the TCC judge’s reasoning was inadequate because it treated the two

transactions in the same way without addressing the factual differences, including the specific wording of the purchase and sale agreements. As a result, the majority partially allowed Daishowa's appeal, sending the case back to the TCC judge for new findings of fact and a reconsideration of the issues with respect to the Seetha deal.

In his dissenting judgment, Justice Robert Mainville found that the reforestation liabilities should not be included in proceeds of disposition because these liabilities were not a separate consideration but integral to the assets and diminished the value of the assets. Daishowa received a lower price on the sale of the timber properties, and not additional consideration as a result of the assumption of the reforestation liabilities. Thus, those reforestation liabilities were not proceeds of disposition.

While Justice Mainville could have stopped there, he went on to consider the valuation of the reforestation obligations. He agreed with the majority that the TCC judge could not discount the long-term liabilities. However, he found that whether the parties agreed or not on the value of the obligations did not affect whether they were part of the proceeds of disposition. Furthermore, in his view, the two transactions should be treated in the same manner given his basic conclusion that the assumption of this type of obligation was not included in the proceeds of disposition.

SCC's decision

The SCC allowed Daishowa's appeal with relatively concise reasons written by Justice Marshall Rothstein, largely adopting the approach taken by Justice Mainville in his dissenting FCA opinion.

The two issues the SCC considered are summarized below:

1. *Whether the reforestation liabilities were to be included in the proceeds of disposition because the vendor was relieved of a liability or whether they were integral to and ran with the forest tenures.*

The SCC began its consideration of this issue by acknowledging that the assumption of a vendor's liability by a purchaser may constitute part of the sale price and, therefore, also part of the vendor's proceeds of disposition, referring to the example of the purchase of a property encumbered by a mortgage. However, the SCC distinguished the assumption of a mortgage from the assumption of reforestation obligations. The former does not generally affect the value of a property; the latter is more akin to purchasing a property that requires repairs. The reforestation obligations "are a future cost embedded in the forest tenure that serves to depress the tenure's value at the time of sale." (para. 29)

As a result, the SCC concluded that the reforestation obligations could not be separated from the timber assets but were embedded in those assets and depressed the sale price of those assets. As such, they did not have to be added to Daishowa's proceeds of disposition.

A persuasive factor for the Court appeared to be the nature of Alberta's regulatory scheme, which prevents a vendor from selling timber assets without the purchaser assuming the reforestation obligations and, on assumption, relieves the vendor of any future obligation. However, the SCC acknowledged the possibility that obligations associated with a property right could be embedded in that property right "without there being a statute, regulation or government policy that expressly restricts a vendor from selling the property right without assigning those obligations to the purchaser." (para. 36)

The SCC also remarked that the Minister's approach would lead to asymmetry between the vendor's proceeds of disposition and the purchaser's adjusted cost base on the acquisition of timber assets. The reforestation obligations

would be included in the vendor's proceeds of disposition but, according to the Minister, would not be included in the purchaser's adjusted cost base. While the SCC indicated that this would not be dispositive of the appeal, it confirmed that an interpretation of the *Income Tax Act* that promotes symmetry and fairness is preferred.

Daishowa had argued in the alternative that the reforestation obligations should not be added to its proceeds of disposition because they were a contingent liability. The SCC indicated that this argument was "misplaced and appears to have caused some confusion in the courts below" by implicitly accepting that reforestation obligations are not embedded in the forest tenure (para. 40). According to the SCC, since the cost of reforestation was not a distinct liability of the vendor and was instead embedded in the timber assets, it would be excluded from proceeds of disposition whether or not it was regarded as absolute or contingent.

2. *Whether it makes any difference that the parties agreed to a specific amount of the future reforestation liability?*

Since the SCC concluded that the assumption of reforestation obligations was not included in Daishowa's proceeds of disposition, it did not make any difference whether the parties had agreed upon a value for such obligations. Any agreed-upon value would simply be a factor in determining the overall value of the timber assets. Furthermore, the SCC concluded that Daishowa was not required to include the accounting estimate of future reforestation, added back to accounting income at the time of the sale, in its proceeds of disposition as financial accounting and income tax have distinct purposes.

Conclusion

This decision will have a significant impact on the tax treatment of the assumption of certain types of obligations, particularly in the forestry, mining and oil and gas industries. The SCC distinguishes between obligations that do not affect the value of specific assets, such as a mortgage – the

assumption of which would be included in proceeds of disposition – and obligations that affect the value of property, such as the need for repairs – the assumption of which would not be included in proceeds but rather reduces the value (and therefore the purchase price) of the property. The SCC was comforted with the fact its conclusion was avoiding asymmetry between vendor's and purchaser's tax treatment.

The decision suggests that the assumption of liabilities that do not affect the value of specific assets would be considered proceeds of disposition to the vendor because such liabilities are not embedded in a specific property right. The question arises as to whether obligations such as pension deficits or post-retirement benefit obligations are liabilities that affect the value of a specific property right, such as workforce in place and/or goodwill, or whether the agreed estimate of these liabilities should be included in proceeds of disposition to the vendor.

It remains for a future case to determine whether the assumption of obligations of this nature, whether included in the vendor's proceeds or not, should be reflected as an addition to the cost of the assets acquired by the purchaser. And if so, whether such an addition occurs at the time of acquisition or at a later date when the expense is actually incurred, or whether the purchaser can claim a deduction for such expenses when actually incurred (for example, as a running expense of the business). In this regard, "purchase accounting" considerations should not be determinative as to the appropriate applicable tax treatment.

This decision reinforces the importance for taxpayers selling assets to consider carefully the wording of the contract and any related documentation and to describe clearly the elements of the contract for which consideration is paid by the purchaser. Special attention should be given as to whether obligations of the seller that are assumed by the purchaser are intended to constitute consideration.

Learn more

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