NEWS ANALYSIS

Canada Clarifies Treatment of Assumed Liabilities

by Steve Suarez

The Supreme Court of Canada (SCC) on May 23 wrote the final chapter in an important tax case that has been closely watched by the Canadian tax community when it released its decision in *Daishowa-Marubeni International Ltd. v. The Queen* (2013 SCC 29). (Prior coverage: *Tax Notes Int'l*, Oct. 15, 2012, p. 255.)

The case deals with an issue of considerable commercial importance: the tax treatment of liabilities and obligations that relate to a property being sold and that are being assumed or inherited by the purchaser. While this decision is particularly important to the natural resources sector, considering the magnitude of such obligations frequently inherited by a purchaser of mining, timber, or oil and gas assets, the issue arises in asset acquisitions of all types. The Canadian tax treatment of these obligations is (perhaps surprisingly) less than clear because of inconsistency in the jurisprudence.

A 2-1 majority of Canada's Federal Court of Appeal (FCA) had previously decided that the vendor of some forestry properties (Daishowa) had not included in its disposition proceeds a sufficient amount relating to its liabilities that had been assumed by the purchaser as part of the asset sale. Specifically, the majority concluded that despite the way the purchase and sale agreement had been drafted, the parties had attributed a value of C $11 million to the relevant liabilities, and therefore, that amount should have been included in the seller's sale proceeds for tax purposes, along with the cash received from the purchaser.

In a unanimous decision of the full nine-member bench, the SCC overturned the decision of the FCA majority and found in favor of the taxpayer, concluding that no portion of the reforestation obligations assumed by the purchaser should have been included in Daishowa's disposition proceeds. The SCC found that the liabilities in question were inextricably linked to and embedded in the property being sold, and as such, were simply a feature of the properties themselves that reduced their value, and not distinct liabilities that, when assumed by the purchaser, could constitute additional sale proceeds. Moreover, that conclusion did not depend on whether the liabilities were absolute or contingent, or on whether the parties agreed to a specific amount relating to the liabilities, the SCC said.

Its decision is clear, well reasoned, and is the correct result of law, and it will bring welcome certainty to what had been a troublesome area of Canadian tax law.

Facts

In 1999 the taxpayer (Daishowa) decided to sell two sawmills and the related rights to cut timber on surrounding land. The more valuable of the two mills, High Level, received bids from several interested parties, with a bid from Tolko Industries Ltd. judged the best. Tolko bid C $180 million, less the estimated amount (to be determined) of the long-term obligation of the owner of the land to plant new trees to replace those cut down. Provincial law required that the reforestation liability be assumed by any buyer of the property (that is, it was not legally possible to transfer the High Level property to Tolko without Tolko assuming the reforestation obligation), thereby relieving Daishowa of the obligation to reforest.

Based on the tax advice of an accounting firm, Daishowa accepted Tolko's bid but negotiated for the purchase and sale agreement to state the purchase price of the property as C $169 million, with Tolko inheriting the reforestation obligation and Daishowa representing that its estimate of the cost of fulfilling that obligation was C $11 million. The parties agreed to have a reforestation statement prepared and audited by an accounting firm, and for Daishowa to make a payment to Tolko if the amount determined on the statement was greater than C $11 million (or the reverse if less than C $11 million). The reforestation statement estimated the cost of reforestation at C $11,296,225, and Daishowa returned C $296,225 to Tolko.

The second mill, Brewster, was sold to another buyer in 2000 for C $6.1 million. Daishowa's obligation to reforest the property was again assumed by the buyer without any overt mention of that being part of the purchase price. (In fact, the Brewster agreement specified that the purchaser was receiving no credit for the assumption of the reforestation obligation.) In this case, the sale agreement contained no representation by Daishowa regarding the estimated amount of the reforestation liability or any provision for a related post-closing adjustment.

In both cases, Daishowa did not include in its disposition proceeds any amount relating to the reforestation liabilities assumed by the purchasers. The Canada Revenue Agency reassessed Daishowa in both cases to increase its disposition proceeds: by C $11 million in the High Level sale and, in the Brewster sale, by an amount (C $3 million) shown in Daishowa's presale interim financial statements as the amount of the reforestation liability under generally accepted accounting principles.

Tax Court of Canada

The Tax Court of Canada (TCC) held that some of the amounts relating to the reforestation obligations should have been included in Daishowa's sale proceeds. It said Daishowa was clearly better off economically as a result of the purchaser assuming those liabilities, noting in particular that Daishowa and the CRA

had agreed that in the High Level sale, ''if Tolko had not assumed [Daishowa's] silviculture liability, the amount of cash or other consideration it would have paid [Daishowa] would have increased.''

However, the TCC did not accept that the C $11 million and C $3 million amounts assessed by the CRA reflected the value of those obligations for purposes of determining Daishowa's disposition proceeds. Instead, the TCC increased Daishowa's disposition proceeds by the sum of the current portion of those amounts for accounting purposes, plus about 20 percent of the long-term portion (substantially discounting the long-term portion of the obligation). The TCC dismissed a secondary argument advanced by Daishowa that it should be allowed a deduction for the reforestation obligations for having ''paid'' (that is, delivered valuable assets to) the purchasers in consideration for assuming those obligations. Daishowa appealed, arguing that no amounts should be added to its sale proceeds, and the CRA cross-appealed, asking for the full C $11 million and C $3 million amounts to be included.

Federal Court of Appeal

The majority of the FCA concluded that the reforestation liabilities assumed by the purchasers should be included in Daishowa's ''proceeds of disposition,'' as that term includes not only money received but also other forms of valuable consideration, including liabilities of the seller that are assumed by the purchaser. The FCA majority was unwilling to exclude the assumed liabilities from the disposition proceeds simply because the purchase price (as defined in the purchase and sale agreement) had been structured in a way that did not formally include them; the assumption of those obligations was clearly part of the transaction, they said.

The amount to be included for the obligations was a separate question. The FCA majority found that in the case of the High Level property, Tolko and Daishowa had quantified the value of the reforestation liability as C $11 million (noting in particular the exact dollar amount arrived at by the accountants), and said that amount should therefore be added to Daishowa's disposition proceeds. The fact that Daishowa paid interest on the C $296,225 post-closing adjustment payment further supported the conclusion that the assumption of those liabilities was part of the sale proceeds, the FCA majority held. In their view, it was irrelevant that the original C $11 million figure was an estimate; what mattered is that it was the value that the parties had attributed to the reforestation obligation.

The FCA majority also dismissed Daishowa's alternative argument that if the reforestation-related amounts were included in its sale proceeds, it should be entitled to an offsetting deduction because it in effect paid the buyer to assume the obligations and any such payment would be capital in nature and not deductible from income.

Turning to the Brewster property specifically, the FCA majority found that the TCC's reasons were insufficient to support its treatment of the sale in the same way as the High Level sale and (having inadequate evidence to reach its own conclusion) referred the disposition back to the TCC for further consideration consistent with the principles established by the FCA majority.

The FCA's minority dissent included nothing relating to the reforestation liabilities in Daishowa's disposition proceeds. The dissent found that because the purchaser was required to assume the reforestation obligations in order to obtain provincial government approval for any transfer of assets, there was no basis for treating that assumption as incremental sale proceeds to the vendor. Instead, those obligations inherently depressed the value of the land to which they were ''inextricably linked,'' so that lands otherwise worth C $180 million that were subject to an obligation (estimated by the parties to be C $11 million) were inherently worth no more than C $169 million, which should be the vendor's proceeds for tax purposes. In the dissent's view, only obligations that are not an inherent part of the subject property can be included in the seller's sale proceeds on an assumption by the purchaser; liabilities that are an inextricable part of the property simply depress its fair market value and are thereby accounted for in the purchase price, the minority said.

Supreme Court of Canada

The SCC began by noting that it is certainly possible for a vendor's liability that is being assumed by a purchaser of assets to constitute part of the vendor's disposition proceeds. The obvious example is a mortgage on a property that is a liability severable from the property itself (that is, it is possible to transfer the property without transferring the liability). A vendor selling a property worth C $100 that has a C $30 mortgage on it can either:

- sell the property unencumbered by the mortgage for C $100 in cash, and then use C $30 of the proceeds to repay the mortgage; or
- sell the property encumbered by the mortgage (meaning that the purchaser assumes the C $30 liability) for C $70 in cash.

In either case, the vendor has C $100 of value to sell and is receiving C $100 worth of value in return.

While the CRA sought to analogize the obligations being assumed by Tolko to this scenario, Daishowa's facts were quite different. The courts at all levels found that the reforestation obligations applicable to the High Level property were not severable from that property and were embedded in it.[1] As such, the analogy to a

[1]The SCC noted (at para. 30):

(Footnote continued on next page.)

mortgage is simply not apt, because the obligations in question form part of the FMV of the property they are embedded within, the SCC said. With reference to the forest tenures sold to Tolko, it said (at para. 31):

> The effect of Alberta's scheme is to embed the reforestation obligations into the forest tenure, such that the obligations cannot be severed from the property itself. As such, the reforestation obligations are simply a future cost tied to the tenure that depresses the value of the tenure. . . . [T]he record establishes that Tolko valued the High Level Division's forest tenure at $31 million less the $11 million estimated cost of future reforestation obligations. The forest tenure thus had a value of $20 million. To include the full $31 million in DMI's proceeds of disposition would disregard the fact that DMI did not have $31 million of value to sell.

Viewed properly, based on the actual legal rights and obligations of the parties, it was clear to the SCC that the reforestation obligations were already accounted for by the parties in determining the FMV of the property and that purporting to add an estimate of their eventual cost would overstate Daishowa's disposition proceeds.[2] In that regard, the SCC explicitly left open the possibility (without deciding) that obligations other than those that must, as a matter of law, be assumed by a purchaser of the property in order for the vendor to sell the property could be sufficiently embedded within a property in such a way that the same analysis would apply.

The SCC went on to make two further points:[3] First, the Court made clear that its reasoning did not depend on whether the obligations in question were contingent or absolute. And second, it was also irrelevant whether the parties had agreed on any specific estimate or value of the obligations in question, or whether they had been quantified for accounting purposes.

Comments

While the SCC's emphatic decision brings this case to a logical and welcome conclusion, there are a few important points that can be made going forward. First, when planning and documenting a transaction, it is imperative to have a complete understanding of what it is the vendor owns and what the respective legal rights and obligations of the vendor and purchaser are, and to be sure that the documentation accurately reflects this. Once it is understood that the reforestation obligations could never legally be severed from the property being sold and that they were simply an embedded feature of that property that affected its value, the right tax result becomes reasonably clear (as the unanimous nature of the decision reflects).

This in turn leads to the second point, which is that the way in which the legal issue is framed for the tax authorities and the courts very much affects the way in which they will look at it. The courts at all levels noted the agreed taxpayer/CRA statement before the TCC that ''[i]f Tolko had not assumed [Daishowa's] silviculture liability, the amount of cash or other consideration it would have paid [Daishowa] would have increased.'' However, the premise of this statement is that Daishowa could have sold the property to Tolko without transferring the reforestation liability to the purchaser, which was simply not legally possible. It is this legal distinction that the SCC (and the FCA minority) correctly concluded differentiated Daishowa's situation from a sale of a property encumbered by a mortgage or other non-embedded liability.

As noted in earlier commentary on the FCA decision, had the statement been phrased differently (such as, for example, ''if there was no silviculture obligation associated with the property, the property would have been worth more''), the courts might have viewed the case quite differently.

In any event, with the book now closed on the *Daishowa* case, the Canadian tax community can proceed with an increased and very welcome degree of certainty regarding the tax treatment of liabilities and obligations assumed by a purchaser of assets.

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In this case, the reforestation obligations are embedded in the forest tenure by reason of the policy and practice of Alberta. As described above, Alberta law provides that a forest tenure may be transferred only with the consent of the appropriate provincial official . . . That is, 'the situation in Alberta is that the Province effectively forces the purchaser to assume the reforestation liability: no assumption — no transfer of forest tenures': para. 26. Further, Alberta takes the position that after an assignment has been approved by the province, the vendor is absolved of all liability for the reforestation obligations.

[2]The SCC noted (at paras. 41-43) that its conclusion prevented what would otherwise be an asymmetrical result advanced by the CRA of the vendor including the estimated value of the liabilities in its disposition proceeds and the purchaser not obtaining recognition for them in its acquisition cost.

[3]*See* paras. 40 and 44-46.