

News Analysis: Canadian Appellate Court Issues Split Decision on Transferred Liabilities

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COUNTRY DIGEST

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A majority of Canada's Federal Court of Appeal (FCA) on September 23 held that the value of the liabilities connected to a property sold by a taxpayer should be included in the sale proceeds for tax purposes.

When a taxpayer sells property, the purchaser often assumes or inherits liabilities and obligations related to the property as part of the transaction. This occurrence (and the size of these obligations) is especially significant in the natural resources sector but is found in asset acquisitions of all types. The tax treatment of these obligations is sometimes unclear in Canada, because the jurisprudence is sometimes inconsistent.

The FCA's decision in *Daishowa-Marubeni International Ltd. v. The Queen* illustrates the difficulty with this issue from the seller's perspective. A 2-1 majority of the court allowed the Crown's cross-appeal from the Tax Court of Canada's decision and concluded that the taxpayer had not included in the proceeds of disposition of some properties a sufficient amount relating to liabilities that had been assumed by the purchaser. Specifically, the majority concluded that despite the way the purchase and sale agreement had been drafted, the parties had attributed a value of \$11 million to the relevant liabilities and that amount should therefore be included in the seller's sale proceeds for tax purposes along with the cash received from the purchaser. (For the decision, see *Doc 2011-20940* or *2011 WTD 193-16*.)

Though it may not be the correct result, the decision will constitute a binding precedent on taxpayers unless the Supreme Court of Canada hears an appeal and overturns it.

Facts

In 1999 Daishowa decided to sell two sawmills and the related rights to cut timber on surrounding land. The more valuable of the two mills, High River, received bids from several interested parties, with the bid from Tolko Industries Ltd. judged the best. Tolko's bid

offered \$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 subject property and resulted in Daishowa being relieved of the obligation to reforest.

After receiving tax advice from an accounting firm, Daishowa accepted Tolko's bid but negotiated for the purchase and sale agreement to reflect a different structure. The purchase price for the property was stated as \$169 million, with Tolko inheriting the reforestation obligation and Daishowa representing that its estimate of the cost of fulfilling that obligation was \$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 the buyer if the amount determined on the statement was greater than \$11 million (or the reverse if less than \$11 million). The reforestation statement estimated the cost of reforestation at \$11,296,225, resulting in a payment of \$296,225 by Daishowa to Tolko.

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

In neither case did the taxpayer include in its proceeds of disposition any amount relating to the reforestation liabilities assumed by the purchaser. The Canada Revenue Agency reassessed Daishowa in both cases to increase its proceeds of disposition: in the High River sale, by \$11 million, and in the Brewster sale, by an amount (\$3 million) shown in Daishowa's pre-sale interim financial statements as the amount of the reforestation liability under generally accepted accounting principles.

Tax Court

The Tax Court of Canada held that some of the amounts relating to reforestation obligations should be included in the taxpayer's sale proceeds. The Tax Court acknowledged that Daishowa was clearly better off economically as a result of the purchasers assuming those liabilities and noted the taxpayer's admission that it would otherwise have received higher cash sale proceeds, but it did not accept that the \$11 million and \$3 million amounts agreed to by the parties reflected the value of those obligations for purposes of the sale. Instead the Tax Court increased Daishowa's proceeds of disposition by the sum of the current portion of those amounts for accounting purposes plus about 20 percent of the long-term portion (that is, substantially discounting the long-term portion of the obligation). Daishowa appealed, arguing that no amounts should be added to its sale proceeds, while the CRA cross-appealed, asking for the full \$11 million and \$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 sale proceeds. The term "proceeds of disposition" includes not only money received but also other forms of valuable consideration, including liabilities of the seller assumed by the purchaser, it said. The court was unwilling to exclude the assumed liabilities from the proceeds of disposition simply because the purchase price (as defined in the purchase and sale agreement) had been structured so as not to formally include them; the assumption of those obligations was clearly part of the transaction.

The amount to be included for the obligations was a separate question. Here the court found that Tolko and Daishowa had quantified the value of the reforestation liability Tolko was assuming as \$11 million (noting in particular the exact dollar amount arrived at by the accountants), and accordingly, that was the amount to be added to Daishowa's proceeds of disposition. That Daishowa paid interest on the \$296,225 post-closing adjustment payment further supported the fact that this assumption was part of the asset sale, the court held.

That the original \$11 million figure was an estimate was not germane, in the court's view — what was important was that the parties had agreed to it. The contractual process of establishing \$11 million as a reference point and then providing for an adjusting payment in case the audited estimate turned out to be greater or less than \$11 million constituted an agreement to assume for \$11 million. The court wrote:

The jurisprudence . . . does not ask whether the liability assumed by the purchaser is contingent or absolute; as a matter of fact, the nature of the liability assumed by a purchaser is irrelevant. Instead, the jurisprudence seems concerned only

with the value attributed by the parties, if any, to the liability assumed by the purchaser. If the parties attribute no value to a future liability, then there is nothing to be added to the seller's proceeds of disposition for the purposes of taxation. . . . In the present matter, while Tolko's future reforestation costs are likely uncertain or contingent, there is nothing uncertain or contingent about the consideration paid for the assumption of the liability.

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

Regarding the Brewster property, the court found that the Tax Court's reasons were insufficient to support its treatment of the sale in the same way as the High River sale. There were significant factual differences between the two sales, the court said. Having no evidence to work with, the court referred the disposition of the Brewster sale back to the Tax Court for further consideration consistent with the principles established by the FCA majority.

Dissenting Judgment

The dissent advocated for including nothing in the taxpayer's proceeds of disposition relating to the reforestation liabilities. The dissent found that because the purchaser was effectively 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. Those obligations inherently depressed the value of the land to which they were "inextricably linked," such that lands otherwise worth \$180 million that were subject to an \$11 million obligation were inherently worth no more than \$169 million, which should be the vendor's proceeds for tax purposes, the dissent said. 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.

Comments

The tax treatment of assumed liabilities is complex, which may explain why a case like this, despite having seemingly simple facts, produced completely different approaches from the trial judge, the majority, and the dissent.

Even though it won the case — at least regarding the High River property — the CRA likely won't be entirely satisfied with the result. If the question of

what amount to include in the vendor's proceeds of disposition depends completely on whether the parties choose to allocate any amount to it, most taxpayers will probably allocate very little to assumed liabilities in circumstances like these. An amount added to the vendor's proceeds will generally trigger an immediate tax liability for it (subject to the availability of any tax shelter such as offsetting deductions or losses), while any corresponding increase in the purchaser's tax attributes (that is, deductible expenses or basis of acquired assets) is often of insignificant tax value for many years. On an aggregate basis, the parties are generally better off allocating nothing to the assumed liabilities and perhaps giving the purchaser credit for any lost tax attributes in some other element of the agreement. It is not obvious that this is an advantageous result for the CRA.

More fundamentally, there seems to be confusion about what was purchased and sold, a point illustrated in the FCA dissent. It is this element of the case that appears to give rise to the following diverging views.

The trial court wrote that:

Daishowa could not sell the forest tenures without getting rid of the reforestation liability[,] and by selling the forest tenures, because of Alberta's law and policy, it was no longer liable for those future expenses. The new owner was liable.¹

That being the case, it seems the taxpayer was not selling a property worth \$180 million for consideration consisting of \$169 million of cash and the assumption of an \$11 million liability, because there was no property worth \$180 million to sell. Instead, the taxpayer had a property whose value, taking into account the deficiencies and obligations inherently associated with it, was \$169 million. The taxpayer didn't have \$180 million of value to convey to the purchaser; it was not legally possible to separate the property itself from the reforestation obligations that necessarily accompanied it. Having only \$169 million of value to convey and dealing with an arm's-length purchaser, the seller logically can have received only \$169 million in sale proceeds.²

The FCA dissent cited the analogy of a building that requires expenditures in order to meet legislated standards for safety and access for the disabled. A buyer would take the obligation to perform those repairs into account in valuing the building, but it can't be considered a liability separate from the ownership of

the building; one incurs the obligation by virtue of owning the building. The costs of compliance reduce the value of the building, and no one would consider the seller merely by selling the building to have discharged itself of a liability in a manner that requires the estimated costs to be added to its proceeds of disposition. The obligation or deficiency is simply an inherent part of the asset and is taken into account in valuing it.³

At both the trial level and in the majority appellate judgment, it was noted that the taxpayer had admitted that "if Tolko had not assumed the [taxpayer's] silviculture liability, the amount of cash or other consideration it would have paid the [taxpayer] would have increased." That statement — and its phrasing — was important, because it seems to have encouraged the courts to view the reforestation obligation as something that could be severed from the underlying property and bargained for as a distinct item, rather than merely a feature of that property to be included in its valuation. Had the statement been phrased differently (for example, "if there was no silviculture obligation associated with the property, the property would have been worth more"), the courts might have approached the case differently.

Admittedly, the reforestation obligation isn't as clearly an inherent feature of the property as, say, its location or the number or quality of trees on it, and the manner in which events unfolded muddied the waters. The principle is the same, however, and the dissent of Justice Robert Mainville distinguishing between obligations that form an inherent part of property and distinct liabilities that can be transferred from party to party without regard to ownership of property should be considered the better view.⁴ While there are other alternatives for approaching the question that reach a similar result (and may be relevant in dealing with assumed liabilities that are not an integral part of any

³This approach is consistent with the view expressed in Gamble, *Taxation of Canadian Mining* (Carswell), at 6-10, commenting on mining reclamation obligations: "They depress the value of the mine, but are not liabilities as such. On this view of the matter, on the sale of a mine the 'assumption' of future reclamation obligations should not be regarded as additional proceeds of disposition. The view is simply that the seller receives less consideration on the sale than it might otherwise have received."

⁴At para. 143 of the FCA decision:

The reforestation liabilities either form an integral part of the forest tenures and depress their value and are thus not to be included as separate elements in the proceeds of disposition upon the sale of the tenures; or they are distinct from the tenures and their value is included in the proceeds of disposition upon their assumption by the purchaser. Whether the parties have agreed or not to the value of the liabilities has little bearing on whether or not these liabilities form part of the "proceeds of disposition."

¹Para. 40 of the Tax Court decision, available at <http://decision.tcc-cci.gc.ca/en/2010/2010tcc317/2010tcc317.html>.

²That the taxpayer could have spent money on reforestation before the sale and thereby increased the value of its property by altering its inherent characteristics doesn't change that the property as it was at the time of sale was worth \$169 million to an arm's-length purchaser.

property),⁵ the dissent's reasoning is appropriate for dealing with *Daishowa's* facts. However, unless the Supreme Court of Canada hears an appeal and decides differently, the majority decision will control.

Another lesson from the case is the importance of getting tax input on the formulation of the business transaction as early as possible. The courts were clearly influenced by the change in the computation of the purchase price between Tolko's initial bid and the purchase and sale agreement, a change that served to highlight the treatment of the assumed liabilities. In-

⁵For example, treating the amount of the assumed liability as a selling expense that should be deducted from the vendor's proceeds of disposition, or treating that amount (which relates to an expense that would have been currently deductible to the vendor if incurred on actual reforestation) as a payment in satisfaction of its reforestation obligation. These are questions for another day. On *Daishowa's* facts, however, the minority's approach is simpler and more logical.

deed, the characterization of the reforestation obligation by the parties as an assumed liability requiring special treatment further affected how it was viewed for tax purposes. Having tax involvement (preferably protected by solicitor-client privilege, which is available to lawyers but not accountants in Canada) as early as possible in the transaction is always advantageous.

The treatment of assumed liabilities is of greater importance in the natural resources sector, so taxpayers in those industries must be particularly careful in dealing with inherited obligations, being mindful of the principles established by the court (which seem to offer some opportunities for planning). Though the case doesn't deal with all the relevant issues in this area, the principles established in *Daishowa* are relevant to any type of asset transfer, and parties to sales of assets of all types should take care to produce the tax results that they intend and that reflect the underlying economics of the transaction. ♦

♦ *Steve Suarez, partner, Borden Ladner Gervais LLP, Toronto*