SCC Tax Judgment Important to Mining Industry

By Steve Suarez, Borden Ladner Gervais LLP

Companies in the natural resources sector typically incur significant obligations related to remediating the properties on which they operate. The tax treatment of these obligations was thrown into doubt by a case that was finally resolved in May 2013 by the Supreme Court of Canada (which hears tax appeals only in cases of national importance).

Facts

The taxpayer (DMI) in *Daishowa-Marubeni International Ltd. v. The Queen* was a forestry company that decided to sell a timber mill and related timber rights. Under the Alberta regulatory regime, the buyer was required to assume DMI's existing obligations to reforest the lands it had harvested. The buyer offered $180 million for the property, less an amount reflecting the estimated reforestation costs ultimately quantified as $11 million.

The transaction was structured as a sale for $169 million, with the buyer assuming the reforestation obligation. DMI reported its sale proceeds for tax purposes as $169 million, while the CRA re-assessed DMI's proceeds as being $180 million ($169 million in cash and $11 million in assumed liabilities).

The Tax Court of Canada included a portion of the disputed $11 million in DMI's proceeds. In a 2 to 1 appeal decision, the Federal Court of Appeal added the entire $11 million to DMI's proceeds. The SCC reversed the FCA and ruled 9 to 0 in favour of the taxpayer that none of the $11M should be included in DMI's proceeds.

Analysis

The SCC acknowledged that a buyer's assumption of a vendor's liability can constitute part of the vendor's proceeds of disposition: for example, a property that is encumbered by a mortgage. If the purchaser pays the sale price by paying some cash and assuming the mortgage, then both the amount of the cash and the mortgage liability assumed are included in the vendor's proceeds of disposition.

The critical difference in DMI's case however was that the relevant reforestation obligations were **not** a distinct existing liability comparable to a mortgage. Instead, the SCC found that the Alberta regulatory scheme embedded the reforestation obligations in the property being sold (i.e., they could not be separated from one another because the buyer was required by law to assume these obligations). As such, the timber lands were more analogous to property in need of repair (e.g., a car with a dent in it) than property encumbered by a severable obligation, such as a mortgage.

It is helpful to determine the value of what DMI had to sell, since in an arm's-length transaction it is difficult to see why DMI's proceeds for tax purposes should be greater than that value. Here, because the remediation obligations were embedded in the property (the buyer could not acquire the property without these obligations), the reality was that DMI had a property that was worth $169 million. Much like a car with a dent in it that would be worth more if the dent didn't exist, DMI's property would have been worth $180 million had there been no reforestation obligation. However, the embedded reforestation obligation meant that DMI's property was only worth $169 million, and logically its proceeds for that property were the same amount.

Amongst the various problems with the CRA's position was the fact that it refused to allow the buyer to add the $11 million of assumed obligations to its cost of the purchased property, meaning that if the buyer sold the same property the next day on the same terms, it would have a "phantom" gain of $11 million. The SCC was deeply troubled by this potential double-taxation, and rightly rejected the CRA's approach.

Conclusion

This case provides welcome certainty to the mining sector, where liabilities such as those addressed in *Daishowa* are both large and frequent. That this case needed to go to the SCC to be resolved highlights how important it is to ensure that transactions are structured and documented so as to correctly reflect the parties' rights and obligations, such that the CRA understands them correctly: clearly the lower courts had some confusion as to what was being purchased and its value.

In particular, embedded obligations should be characterized as such (i.e., described as a feature of the relevant property), and not included in the sale price. Taxpayers can help themselves by getting tax advice early in the sale process and ensuring that such advice is protected by solicitor-client privilege. For more on the *Daishowa* decision go to www.miningtaxcanada.com. M

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