In this connection, Stratas J observed that

> CIBC World Market's first method was used consistently throughout the 1998 and 1999 taxation years. Its second method was also used consistently throughout the 1998 and 1999 taxation years.[14]

Therefore, subsection 141.01(5) did not bar CIBC's revised claim for ITCs. CIBC did not attempt to use one allocation method for one part of the year and another allocation method for another part of the year. Instead, CIBC merely used an alternative and more favourable allocation method, which it applied retroactively throughout the entire year. Since CIBC applied the second allocation method consistently throughout the 1998 and 1999 taxation years, it was not offside subsection 141.01(5) in seeking to use the second method instead of the first. Accordingly, the appeal was allowed.

Conclusion

This decision is to be commended. The Tax Court's finding suggests that a choice of allocation method is tantamount to an irrevocable election, an interpretation that is not supported by the text of subsection 141.01(5). The provision directs that the method must be fair and reasonable and used consistently throughout the year, but does not restrict a registrant's choice of method in any other way (including using another fair and reasonable allocation method consistently throughout the year).

Although the introduction of section 141.02 of the Act has rendered this decision moot for financial institutions, the judgment effectively gives other registrants that are required to allocate their inputs among taxable and exempt supplies "a second kick at the can" to change an initial ITC allocation and increase the ITCs in a subsequent GST return filed within the limitation period.

Dalia Hamdy

TIMBER! CONSEQUENCES OF ASSUMING REFORESTATION OBLIGATIONS

Daishowa Paper Manufacturing Ltd. v. Canada
2011 FCA 267

KEYWORDS: DISPOSITIONS ■ TIMBERLAND ■ SALES ■ LIABILITIES ■ ASSIGNMENT ■ AGREEMENTS

Introduction

On September 23, 2011, the Federal Court of Appeal released its decision in *Daishowa Paper Manufacturing Ltd. v. Canada*.[15] The issue in *Daishowa* was whether

14 Ibid., at paragraph 50.

15 2011 FCA 267.

silviculture reseeding liabilities imposed by provincial law that were assumed by a purchaser of a timber resource property constituted proceeds of disposition to the vendor. In a split decision, the court decided that the assumed liabilities properly must be included in the vendor's proceeds. The decision is significant, if not controversial, since the majority and the dissenting opinions illustrate two very different conceptual approaches to the proper treatment of the assumption of a legal obligation imposed by a regulatory regime to remediate and rehabilitate land.

Facts

In the 1990s, the taxpayer ("Daishowa") operated pulp mills in Peace River, Alberta and Quesnel, British Columbia. These pulp mills were part of an operational division and included timber rights consisting of forest management agreements and timber limits, each of which was, for tax purposes, a "timber resource property."[16]

Under Alberta law, as an owner of timber rights, Daishowa was required to provide reforestation plans annually to the provincial government and to reforest all lands that it cleared. (These obligations are referred to herein as "silviculture liabilities.") The same law and related regulatory policies provided that a company's silviculture liability was not satisfied until a sufficient reforested tree crop passed a specified free-growing growth point, which was typically reached between 8 and 14 years from the date of cutting. Most significantly, Alberta law prohibited the transfer of timber rights unless the purchaser assumed the silviculture liabilities imposed by law.[17]

In 1999, Daishowa decided to sell two sawmills and the related timber rights. The successful bidder for its High Level mill, Tolko Industries Ltd. ("Tolko"), offered $180 million less the estimated amount (to be determined) of the silviculture liabilities. At the suggestion of Daishowa's accountants, the agreement was concluded on the basis that the purchase price was $169 million with Tolko also assuming certain liabilities related to the business, including the silviculture liabilities. If an audited postclosing estimate of the silviculture liabilities exceeded Daishowa's estimate, the difference would constitute an adjustment to the purchase price. Specifically, if the amount determined by that reforestation statement was greater than $11 million, Daishowa was obligated to make a payment to Tolko; conversely, if the amount was less than $11 million, Tolko was obligated to make a payment to Daishowa. In fact, the subsequent reforestation statement estimated the silviculture obligations at $11,296,225, resulting in a postclosing payment of $296,225 by Daishowa to Tolko.

The second mill (Brewster) was sold to a different purchaser in 2000 for $6.1 million. Again Daishowa's obligation to reforest the property was assumed by the purchaser, and the agreement specified that the purchaser was receiving no credit for assuming that obligation. In contrast to the High Level mill sale, the sale agreement

16 Defined in subsection 13(21) of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended.

17 Forests Act, RSA 2000, c. F-22, and Timber Management Regulation, Alta. Reg. 60/1973.

did not contain a representation by Daishowa as to the estimated amount of the silviculture liabilities or any provision for a postclosing adjustment relating thereto.

In both cases, in reporting the proceeds from the disposition of the timber resource properties, Daishowa did not include any amount relating to the reforestation liabilities assumed by the purchaser. In reassessing Daishowa, the minister included as proceeds of disposition $11 million in respect of the High Level timber properties and $3 million in respect of Brewster (the latter being the amount of the silviculture liabilities determined under generally accepted accounting principles as shown in Daishowa's presale interim financial statements).

Tax Court of Canada Decision

At the Tax Court of Canada,[18] Daishowa argued that no amount in respect of the silviculture liabilities constituted proceeds of disposition because the value of those liabilities was not determinable when the transaction closed, and that if the foregoing argument was rejected, the actual value that should be included as proceeds in respect of the High Level properties was a lesser amount than the $11 million estimate applied by the minister. Failing that, Daishowa argued that it should be entitled to a deduction from income for having paid each of the purchasers with assets to assume Daishowa's liabilities, which liabilities were deductible when paid since they were on income account.

The court had little difficulty concluding that an amount in respect of the assumed silviculture liabilities should be included as proceeds of disposition, albeit significantly less than $11 million and $3 million (such lesser amount calculated as the sum of the current portion of these amounts for accounting purposes plus about 20 percent of the long-term portion of the liabilities). A crucial element of the court's conclusion was that the liabilities were actually assumed and did not simply follow the transferred properties to the purchasers by operation of law:

> What is the nature of the liability, the relief of which leads to some benefit to Daishowa? It is not one that, as I initially thought, passes automatically with the forest tenures. From a careful review of the Alberta legislation and the Parties' agreed facts, it is clear that the Province of Alberta will not approve of a transfer of the forest tenures, unless a purchaser assumes the reforestation liability. *This is quite different from any suggestion that the liability, simply by the operation of Alberta statutes, flows with the property; in other words, whoever owns the forest tenures is legally responsible for the reforestation obligation*. No, the situation in Alberta is that the Province effectively forces the purchaser to assume the reforestation liability: no assumption—no transfer of forest tenures. Does the fact that a third party, the Government of Alberta, forces an assumption of liability, make the assumption of that liability any less consideration? No, it does not affect the nature of the assumption of liability as consideration, though it may affect the value of that assumption.[19]

18 *Daishowa-Marubeni International Ltd. v. The Queen*, 2010 TCC 317.

19 Ibid., at paragraph 26 (emphasis added).

As noted, Daishowa also argued in the alternative that it was entitled to deduct an amount equal to the assumed liabilities, on the theory that the taxpayer was effectively paying for the purchaser to assume the liabilities. This argument was rejected by the court without much analysis.

Federal Court of Appeal Decision

Daishowa appealed the Tax Court decision, arguing that no amounts should be added to its sale proceeds, while the minister cross-appealed asking for the full $11 million and $3 million amounts to be so included. As noted above, the outcome was a split decision at the Federal Court of Appeal. The majority of the Court of Appeal concluded that the silviculture liabilities assumed by the purchasers should be included in Daishowa's sale proceeds on the basis that the expression "proceeds of disposition" includes not only money received but also other forms of valuable consideration, including liabilities of the vendor assumed by the purchaser. This was the case notwithstanding that the purchase price stipulated in the sale agreement did not explicitly include the assumption of the silviculture liabilities, since in the majority's view those liabilities were clearly part of the transaction. The majority buttressed its conclusion on this point by noting that Daishowa paid interest on the $296,225 postclosing adjustment payment.

As regards the amount to be included, the majority found that Tolko and Daishowa had determined that the value of the silviculture liability that Tolko assumed was $11 million, making specific reference to the precise dollar amount arrived at by Daishowa's accountants. Consequently, in the majority's view, this was the amount that was properly added to Daishowa's proceeds of disposition.

It is significant that the fact that the original $11 million figure was an estimate was not considered by the majority to be particularly relevant, since this was the amount to which the parties had agreed. Instead, the majority determined that the contractual mechanics of establishing $11 million as a reference point and then providing for an adjusting payment in the event that the audited estimate generated a different number constituted an agreement to assume for $11 million. In the majority's view,

> 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 purpose 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 that liability.[20]

The 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

20 *Daishowa*, supra note 15, at paragraphs 79 and 81.

offsetting deduction by virtue of having paid the purchaser to assume those obligations. The majority found that any such payment was a non-deductible capital outlay.

In the case of the Brewster property, the majority found that the Tax Court's reasons were inadequate to support any kind of conclusion on the issue since there were insufficient facts on the record. Consequently, the Brewster sale was referred back to the Tax Court for further consideration consistent with the principles established by the majority.

The dissenting judge concluded that no amount in respect of the silviculture liabilities should be included in Daishowa's proceeds of disposition on the basis that these liabilities inherently depressed the value of the land to which they were "inextricably linked."[21] That is, only obligations that are *not* an inherent part of the subject property could be included in the vendor's sale proceeds on assumption by the purchaser. The conclusion that liabilities that are an inextricable part of the property depress its fair market value was premised on the fact that Tolko was effectively required to assume the silviculture liabilities in order to obtain provincial government approval for any transfer of assets.

Consequently, the dissenting judge held that lands otherwise worth $180 million that were subject to an inherent $11 million obligation were inherently worth no more than $169 million, and that this amount should be Daishowa's proceeds for tax purposes.

What Does This Mean?

The obvious conclusion to draw from the majority judgment is that the amount of a vendor's proceeds of disposition depends solely on whether the parties choose to allocate any amount to a contingent liability. Thus, if there is no evidence that either party placed a value on such liabilities, they will be ignored for tax purposes.

Does this result make sense? On one level perhaps it does, since parties should be free to choose whatever value they see fit as the consideration payable for properties. Presumably the Canada Revenue Agency will not be pleased with this result.

However, fundamentally, the reasoning in the dissenting opinion is preferable, since it draws a sensible distinction between an assumed liability like a mortgage—which has no bearing on the value of a property—and things like dents and scratches and burdensome regulatory regimes, all of which are warts that are a part of a property and affect its value, but cannot realistically be severed (or even analyzed independently) from the property.[22]

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21 Ibid., at paragraph 130.

22 This approach is consistent with the long-held understanding of most practitioners in the resource industry. As expressed in Ian J. Gamble, *Taxation of Canadian Mining* (Toronto: Carswell) (looseleaf), 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."

The trial and appeal decisions are clear that, by operation of Alberta law, Daishowa could not sell the forest tenures without getting rid of the silviculture liabilities, and that, also by operation of Alberta law, the purchaser of the tenures—not Daishowa—would be liable for the future cost of silviculture expenses relating to the properties. Consequently, by reason of the silviculture regulatory regime in Alberta, Daishowa did not sell a property worth $180 million for consideration consisting of $169 million in cash and the assumption of an $11 million liability, because there was no property worth $180 million to sell. That is, Daishowa did not have $180 million of value to convey to the purchaser because it was not legally possible to separate the properties from the obligations imposed by Alberta law. Having only $169 million of value to convey and dealing with an arm's-length purchaser, Daishowa could only have received $169 million in sale proceeds.

The analogy cited in the dissent provides a simple illustration of this approach—namely, a building that requires expenditures in order to meet legislated standards for safety and access for the disabled. The obligation to perform the repairs is something that a purchaser would account for in valuing the building, but is not one that can be considered to be a liability separate from the building because the obligation to spend the money exists by virtue of owning the building. These compliance costs reduce the value of the building below what it would otherwise be, and on sale of the building, no one would view the vendor as being discharged of a liability that requires the estimated costs to be added to proceeds of disposition. Instead, the obligation or deficiency is simply an inherent part of the asset, and is taken into account in valuing it.

To state the principle simply, a requirement to operate business assets in compliance with a regulatory regime such as the reforestation laws in Alberta imposes a burden on the assets that depresses their value in the same manner as a dent reduces the value of a car. Obligations imposed by such a law have no value separate and apart from the assets because they do not exist but for the ownership of the asset. This is in contrast to an obligation like a residential mortgage, which, as noted above, is something that is separate and distinct from the property (since the mortgage can be assumed by the buyer and repaid by the seller) and therefore has no inherent effect on the value of the home.

With this in mind, it is interesting that both the Tax Court and the majority appellate judgment made specific references to Daishowa's admission that "[i]f Tolko had not assumed the [taxpayer's] silviculture liability, the amount of the cash or other consideration it would have paid the [taxpayer] would have increased."[23] This statement appears 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. This, of course, must be wrong since it conflicts with the acknowledgment

23 *Daishowa*, supra note 18, at paragraph 24.

(in all judgments) that the properties could not have been transferred without the assumption of the silviculture liabilities.

Another problem with the reasoning of the majority decision is that it imposes tax on a notional gain that is not represented by an increase in the taxpayer's wealth. Assume, for example, that a forestry company acquires a timber licence for $100. In the first year of operation, the company proceeds to cut and sell timber, resulting in net revenues of $1,000 and an estimated provincial reforestation obligation of $500. The reforestation obligation is not currently deductible in computing income for tax purposes since it is considered contingent. At the end of the year, the company sells the resource property for $100 and the purchaser assumes the reforestation obligation. On an economic basis, the company's total increase in wealth from participating in the venture would be $1,000. However, on the basis of the majority decision in *Daishowa*, the company would be subject to tax not only on its profit from selling timber of $1,000 (without any deduction for the cost of reforestation), but on an additional income gain of $500 from selling the resource property. In the absence of clear parliamentary intent to the contrary, the courts should be reluctant to adopt an interpretation of the Income Tax Act that results in taxes being imposed on a notional gain that is not matched by an equivalent economic gain.

As the (saw)dust settles, one thing is clear: the approaches advocated by the majority and the dissent at the Court of Appeal are diametrically opposed. The taxpayer has sought leave to appeal the decision to the Supreme Court of Canada.

Michael Colborne and Steve Suarez

DEDUCTIBILITY OF STOCK OPTION CASHOUTS DENIED

Imperial Tobacco Canada Limited v. Canada
2011 FCA 308

KEYWORDS: STOCK OPTION PLAN ■ DEDUCTIONS ■ CAPITAL EXPENDITURES ■ BUSINESS EXPENSES ■ ACQUISITIONS ■ CORPORATE REORGANIZATIONS

Introduction

A case comment in a previous issue of this journal[24] analyzed the Tax Court of Canada's December 2010 decision in *Imperial Tobacco Canada Limited v. The Queen*.[25] The comment highlighted the ambiguity left by that decision in conjunction with the court's 2007 decision in *Shoppers Drug Mart Limited v. The Queen*,[26] with respect to the deductibility of amounts paid by an employer in satisfaction of its obligations

24 Kathy Wang, "Deductibility of Stock Option Cashouts Revisited," Current Cases feature (2011) 59:2 *Canadian Tax Journal* 315-21.

25 2010 TCC 648.

26 2007 TCC 636.