CURRENT CASES

Vendor Disposition Proceeds May Exclude Certain Purchaser Assumed Obligations

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On May 23, 2013, the Supreme Court of Canada released its decision in *Daishowa-Marubeni International Ltd. v. The Queen.*[1] This case concerned the tax treatment of liabilities and obligations assumed by a purchaser that relate to an asset being sold. In a unanimous decision, the Supreme Court overturned the decision of the Federal Court of Appeal majority and found, in favour of the taxpayer, that no portion of certain reforestation obligations assumed by the purchaser on the acquisition of timber harvest rights should be included in the vendor taxpayer's proceeds of disposition. While *Daishowa* is of particular importance in the natural resources sector, given the magnitude of reclamation obligations frequently inherited by a purchaser of mining, timber or oil and gas assets, the decision will also have ramifications in other asset acquisitions.

Background

In 1999, the taxpayer ("DMI") decided to sell two timber mill divisions, including the rights to harvest timber on the surrounding land (which were "timber resource properties" for the purposes of the Income Tax Act[2]). Under the terms of the harvest rights, the owner was required to plant and manage a new crop of trees to replace those harvested. The applicable Alberta regulatory scheme provided that the reforestation obligations flowed with the ownership of the harvest rights and the transfer of the harvest rights required the consent of the province of Alberta, which would not approve a transfer unless the purchaser assumed the reforestation obligations.

Several interested parties submitted bids on the more valuable of the two divisions ("High Level").[3] The winning bid offered $180 million, less an amount to be determined in respect of the long-term reforestation obligations associated with the harvest rights.

DMI negotiated with the purchaser for a different structure in the purchase and sale agreement based on tax advice it received from an accounting firm. In the final agreement, the purchase price for the property was stated as $169 million ($20 million of which was allocated to the harvest rights), with the purchaser inheriting the reforestation obligations and DMI representing that the estimated cost of fulfilling those obligations was $11 million. The parties agreed to have a reforestation statement prepared and audited by an accounting firm, and for DMI to make a payment to the purchaser if the amount determined in 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 DMI to the purchaser.

DMI did not include any amount relating to the reforestation obligations assumed by the purchaser on the sale of High Level in its proceeds of disposition. The Canada Revenue Agency ("CRA") reassessed DMI to increase DMI's proceeds of disposition for High Level by $11 million.

Tax Court of Canada

The Tax Court of Canada[4] held that some amount relating to the reforestation obligations should be included in DMI's income. The Court did not, however, accept that the $11 million reflected the value of those

[1] 2013 SCC 29 ("*Daishowa*").

[2] R.S.C. 1985, c. 1 (5th Supplement), as amended, hereinafter referred to as the "Act". Unless otherwise stated, statutory references in this article are to the Act.

[3] The sale of the second division ("Brewster") was also considered by the courts; however, the focus in all three decisions was primarily on High Level and therefore, the sale of Brewster is not discussed by the authors.

[4] 2010 TCC 317 (T.C.C.).

obligations for tax purposes. Instead, the Court held that an amount equal to the current portion of the reforestation obligations (as determined for accounting purposes) plus 20% of the long-term portion should be added to DMI's proceeds of disposition. The Court cited the uncertainty around the actual costs of reforestation and the Alberta regulatory regime as reasons for the significant discount.

DMI appealed, arguing that no amounts in respect of the reforestation obligations should be added to its proceeds of disposition, while the CRA cross-appealed, asking for the full $11 million to be included.

Federal Court of Appeal

A majority of the Federal Court of Appeal[5] approved the finding of the Tax Court that the purchaser's assumption of the reforestation obligations on the High Level sale constituted consideration to DMI; however, the majority disagreed with the lower court as to the appropriate amount to be included in DMI's proceeds of disposition.

As a starting point, the majority decision of the Federal Court of Appeal acknowledged that, as a matter of principle, the phrase "proceeds of disposition" includes money received as well as other forms of valuable consideration, such as liabilities of the vendor assumed by the purchaser. The majority went on to find that the purchaser's assumption of DMI's reforestation obligations constituted consideration that had to be included in DMI's proceeds of disposition for High Level, notwithstanding that the purchase price (as defined in the purchase and sale agreement) had been structured so as not to formally include the assumption of this liability. This conclusion, the majority found, was consistent with the conduct of the parties (even the unsuccessful bidders), the trail of transaction and planning documents and, in particular, DMI's and the CRA's agreed statement at trial that "if the purchaser had not assumed the reforestation obligations, the cash component of the sale price would have been higher".

Having found that some amount should be added to DMI's proceeds of disposition, the Court went on to consider the quantum of that addition. The Court rejected the discount approach followed by the Tax Court, and found that the purchaser and DMI had quantified the value of the reforestation obligations at $11 million (noting in particular the exact dollar amount arrived at by the accountants), and accordingly, that was the amount to be added to DMI's proceeds of disposition.

The dissenting judgment at the Federal Court of Appeal advocated for the exact opposite result: adding nothing to DMI's proceeds of disposition, on the grounds that the reforestation liabilities were an inextricable part of the property and, therefore, the reforestation liabilities simply depressed the value of the property.

Supreme Court of Canada

At the Supreme Court of Canada, a nine-member bench unanimously found that DMI was not required to add any amount in respect of reforestation obligations to its proceeds of disposition for tax purposes, agreeing with the dissenting decision at the Federal Court of Appeal.

The Supreme Court decision acknowledged that as a matter of principle, the assumption of a vendor's liability by a purchaser may constitute part of the sale price and therefore part of the vendor's proceeds of disposition. The Court illustrated this point with a simple example of 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 should be included in the vendor's proceeds of disposition.

However, the Court found that the reforestation obligations associated with High Level were not a distinct existing liability comparable to a mortgage. Instead, the Court made the following findings:

- The Alberta regulatory scheme had the effect of embedding the reforestation obligations in the harvest rights (i.e., they could not be separated from one another), and therefore, the harvest rights were more analogous to property in need of repair than property encumbered by a mortgage.
- As such, the reforestation obligations depressed the value of the harvest rights (i.e., from $31 million to $20 million) and

[5] 2011 FCA 267 (F.C.A.).

therefore, DMI did not have $31 million of value to sell.

- The fact that the parties had agreed to a specific estimate of future reforestation costs made no difference (in contrast to what the Federal Court of Appeal had suggested); rather, the estimate was simply a factor in determining the value of the harvest rights.

Most interestingly, the Court 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 such that the same analysis would apply.

The Court also observed that its conclusion avoided the asymmetry inherent in the CRA's position that would otherwise result as between DMI and the purchaser who, the CRA argued, should not be permitted to add any amount in respect of the assumed obligations to its cost of the harvest rights. In doing so, the Court endorsed the view (at paragraph 43), that "an interpretation of the [Income Tax Act] that promotes symmetry and fairness through a harmonious taxation scheme is to be preferred over an interpretation which promotes neither value".

The Court also considered and dismissed DMI's argument that the contingent nature of the reforestation obligations supported excluding these amounts from its proceeds of disposition. The contingent or absolute nature of the liability was irrelevant in the Court's view – what mattered was whether they were a distinct and severable liability, which they were not.

Observations

The differences in the approaches taken by the various courts that heard *Daishowa* may be attributed to confusion about what, in legal and economic terms, was actually being purchased and sold. The reasons of the Tax Court and the Federal Court of Appeal majority were premised on the understanding that the High Level harvest rights had a value of something more than $20 million, even though both acknowledged that under the Alberta regulatory regime, the purchaser was required to assume the reforestation obligations to complete the sale. The conduct of the parties, the trail of documents (including the bid documents), and the taxpayer's admission at trial that "if the purchaser had not assumed the reforestation obligations, the cash component of the sale price would have been higher", all encouraged the lower courts to view the reforestation obligations as separate obligations that could be severed from the property (like a mortgage) when, in fact, they were invariably obligations of the property's owner, and therefore, inextricably linked to the property being acquired. The taxpayer's agreement that it would have received more cash had the purchaser not assumed the reforestation obligations was particularly unfortunate, as the premise of that statement is simply incorrect: it was legally impossible for the purchaser to acquire the property without taking on the reforestation obligations (unlike a debt secured by a mortgage). A more accurate statement that would have reflected the actual legal and economic rights and obligations of the parties would have been something to the effect of: "if the harvest rights had not been subject to the reforestation obligations, the value of those rights would have been higher".

The Supreme Court, on the other hand, clearly found there was no more than $20 million in value of harvest rights to transfer after taking into account the future cost of the reforestation obligations. Having only $20 million of value to sell and dealing with an arm's length purchaser, DMI should logically have only received $20 million for those harvest rights, and this is demonstrably the correct result in every respect. On different facts, DMI could have had property worth $31 million if, for example, it had spent money prior to the sale satisfying the reforestation obligations embedded in the property and thus enhancing the value of what it had to sell (in which case it would have received the appropriate tax recognition for the amounts it had spent). But those are simply not the facts of *Daishowa*.

The Supreme Court's statement that tax statutes should be interpreted so as to avoid asymmetrical results where possible is potentially very helpful. One would expect that this kind of interpretational guidance from the country's highest court will have considerable

weight, and this principle is likely to be cited frequently in future decisions.

In its decision, the Supreme Court also noted that the accounting treatment of the relevant obligations was not relevant in determining the appropriate result for tax purposes. This case is thus also a welcome reminder of the important basic principle that income is determined under the rules in the Act, not under accounting rules.

The decision in *Daishowa* is certainly welcome and will provide additional certainty on the tax treatment of assumed obligations. Its relevance is broadened further by the fact the Court left open the possibility that its reasoning may apply to obligations beyond those that are required by law to be assumed by a purchaser acquiring property. In addition, taxpayers and their advisors may take a few practice points from the case.

- When planning and negotiating a transaction, it is imperative that the parties have a complete understanding of what it is the vendor owns and the respective legal rights and obligations of the vendor and purchaser.
- The documentation should accurately reflect the parties' understanding at every stage of the transaction, and in particular, should characterize "embedded" liabilities and obligations (to the extent that they need to be explicitly addressed at all) as features of the underlying property value rather than as something severable and distinct from that property.
- To the extent that a purchaser is inheriting "embedded" obligations that cannot be severed from the property, wherever possible, it is preferable to express the purchase price as a net amount (e.g., $20 million) rather than a gross amount ($30 million) to be reduced by some estimate of an "embedded" liability or impairment that the purchaser is inheriting.

The Supreme Court had little difficulty determining the correct tax result in *Daishowa* once the true nature of the transaction was made clear to it, as the 9-0 result illustrates. In that regard, *Daishowa* illustrates that the clearer the parties' understanding of their respective legal rights and obligations and the more precisely these rights and obligations are expressed in the transaction correspondence and documentation, the less likely it will be that the tax authorities will view the transaction as something other than what it is and what the parties intended.