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Daishowa's Burden

by

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> MR. JUSTICE ROTHSTEIN: The two issues that we want to hear you on are [firstly] are the reforestation liabilities included in the proceeds of disposition because they relieve the vendor of a liability or are they integral to and run with the forest tenures? Secondly, does it make any difference that the parties agreed to a specific amount of the future forestation liability?[2]

Background

With these words, the Supreme Court of Canada framed the upcoming debate in *Daishowa-Marubeni International Ltd. v. The Queen*.[3] Readers in Canada will be familiar with the background. In 1999, a Canadian company (Daishowa) sold a "forest tenure" in Alberta to a purchaser for a stated purchase price in cash, plus (or minus) working capital.[4] The original agreement (representing the forest tenure) granted to a predecessor of Daishowa[5] the right to cut or remove timber from the defined lands, but it *also* imposed an obligation on the predecessor to submit reforestation plans and reforest all lands cut over by it.[6]

The sale agreement provided that Daishowa had estimated "in good faith that the aggregate value of the current and long term reforestation liabilities will be $11 million" as at the date of sale. PwC later provided a "reforestation statement" indicating that, in its opinion, "the reforestation liabilities" were $11,296,225 as at the time of sale. Pursuant to an "adjustment clause" in the sale agreement, Daishowa subsequently paid (back) to the purchaser the difference of $296,225.[7]

In filing its tax return for 1999, Daishowa did not recognize any proceeds of disposition in respect of the $11,296,225 of reforestation liabilities. It also did not deduct (in computing its income) any portion of those reforestation liabilities: i.e., neither before, nor as part of, the sale transaction. Although the estimated $11,296,225 obligation to reforest had economically arisen (a portion of the trees had been cut), this economic obligation was contingent in nature because no actual liability (cost) had yet been incurred in physically planting new trees.[8]

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[2] Transcript of the Supreme Court of Canada's oral hearing on the leave application (June 4, 2012).

[3] *Daishowa-Marubeni International Ltd. v. The Queen*, leave granted to the Supreme Court of Canada on June 4, 2012 (leave to appeal from the decision of the Federal Court of Appeal at 2011 FCA 267, which reversed the Tax Court of Canada at 2010 TCC 317).

[4] For convenience, only the sale of the High Level Division forest tenure is discussed here.

[5] Predecessor by amalgamation.

[6] Forest Management Agreement dated December 19, 1996. See also the trial judgment at paragraph 2. The obligation to reforest is also referred to here as the reforestation liability.

[7] Clause 3.2.2(a) of the sale agreement (paragraph 7 of the trial judgment).

[8] See *Northwood Pulp and Timber Limited v. The Queen*, [1999] 1 C.T.C. 53, 98 D.T.C. 6640 (FCA), at paragraph 9: "…the Courts have consistently disqualified for income tax purposes, in calculating taxable profits, amounts that are provisional estimates, are conditional, contingent or uncertain" (the Court of Appeal agreeing with, and quoting, the Trial Judge in that case).

The Canada Revenue Agency (CRA) subsequently reassessed Daishowa to add the full $11,296,225 of estimated reforestation liabilities to Daishowa's proceeds of disposition. No amount was allowed as an offsetting deduction. Daishowa objected and appealed, and had partial success at the Tax Court but lost (by majority decision) at the Court of Appeal.[9]

Limited Scope of this Note – The Questions

The purpose of this note is not to discuss at any length the decisions of the Tax Court or the Court of Appeal. Many excellent papers have been written with that focus.[10] The purpose here is to offer selected thoughts on the debate (the questions) as framed by the Supreme Court.

The Supreme Court's first question – Are the reforestation liabilities included in the proceeds of disposition because they relieve the vendor of a liability or are they integral to and run with the forest tenures? – could be viewed as having (at least) two parts: Did the reforestation liabilities run with the forest tenures? And was the vendor relieved of a liability? This note briefly explores these parts of the first question, both in Alberta and in British Columbia (by comparison).

The note then considers the Supreme Court's second question – whether it makes any difference that the parties agreed to a specific amount. The note ends with some concluding thoughts.

Did the obligation to reforest run with the forest tenures?

Basic Principles

A person who is assigned the benefit of a contract generally obtains the rights (benefits) of the contract but has no automatic liability to perform the obligations (burdens) of the assignor under that contact.[11] This principle also lies at the root of the general rule that positive covenants do not run with the land: a positive covenant being the requirement to lay out money or take some step of an active character.[12] There are, however, important exceptions to these general propositions.

One exception operates by statute: that is, the burdens (or positive covenants) can be made to run with the contract (or land) by a statutory provision.[13] Another exception is usefully summarized by Megarry V.C. in *Tito v. Waddell (No.2)*.[14]

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[9] In this note, the Tax Court of Canada is referred to as the Tax Court, the Federal Court of Appeal is referred to as the Court of Appeal, and the Supreme Court of Canada is referred to as the Supreme Court.

[10] Joseph Frankovic, Supreme Court to Hear Daishowa Appeal – Back to Basics on Basis and Proceeds, CCH Tax Topics, July 12, 2012, Number 2105; *Timber! Consequences of Assuming Reforestation Obligations*, 2012 CTJ 1 p.137/138 Current Cases (Michael Colborne and Steve Suarez); *Let the Buyer (and Seller) Beware: The FCA's Decision in Daishowa*, 2012 TOM 12(1) p.6/7 (Montes, C.) *Unanswered Question: Judicial Recourse*, 2012 CTH 20(1) p.2/3 (Lubetsky, M.); *Assuming Business Liabilities in an Asset Purchase*, 2012 CTF 2(1) p.2 (Spiro, A. and J. Jones) *Current Cases* (David Jacyk, Mark Meredith, John Saunders, and Matthew Turnell), 2012 British Columbia Conference, Canadian Tax Foundation; Steve Suarez, *Supreme Court Grants Taxpayer Leave to Appeal in Daishowa*, Tax Notes Int'l, June 11, 2012, p. 1006 66 Tax Notes Int'l 1006 (June 11, 2012), Tax Analysts Document Number: Doc 2012-12160; Steve Suarez, *News Analysis: Supreme Court Holds off on Daishowa*, Tax Notes Int'l, 66 Tax Notes Int'l 514 (May 7, 2012), Tax Analysts Document Number: Doc 2012-8948; *Purchase and Sale of a Business*, 2011 BCC p.9C:2 (Onufrechuk, S.); Steve Suarez, *News Analysis: Canadian Appellate Court Issues Split Decision on Transferred Liabilities*, Tax Notes Int'l, Oct. 10, 2011, p. 108 64 Tax Notes Int'l 108 (Oct. 10, 2011), Tax Analysts Document Number: Doc 2011-20925.

[11] Treitel, *Law of Contract*, 8th ed. 1991, at pp. 603-4; Fridman, *The Law of Contract*, 6th ed. (2011) at 657; Ziff, *Principles of Property Law*, 3rd ed. (2000) at 366.

[12] *Durham Condominium Corp. No. 123 v. Amberwood Investments Ltd*. 58 O.R. (3d) 481 (Ont. CA), at paragraph 33.

[13] Ibid., at paragraph 51; see, for example, *Industrial and Mining Lands Compensation Act*, R.S.O. 1990, c. I.5, ss. 1-4.

The relevant portions of the discussion are worth setting out here in full:

> An instrument may be framed so that it confers only a conditional or qualified right, the condition or qualification being that certain restrictions shall be observed or certain burdens assumed, such as an obligation to make certain payments. Such restrictions or qualifications are an intrinsic part of the right; you take the right as it stands, and you cannot pick out the good and reject the bad. In such cases it is not only the original grantee who is bound by the burden; his successors in title are unable to take the right without also assuming the burden. The benefit and the burden have been annexed to each other ab initio, and so the benefit is only a conditional benefit.
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> …once the benefit has been taken under the deed, or once the estate has been claimed under the indenture, the burdens are as binding as if the taker of the benefit or estate had executed the instrument…take the benefit, and at once the burdens bind you.[15]
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> …
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> I pause to emphasise that in these cases there is plainly an initial question of construction. If an instrument grants rights and also imposes obligations, the court must ascertain whether on the true construction of the instrument it has granted merely qualified or conditional rights, the qualification or condition being the due observance of the obligations, or whether it has granted unqualified rights and imposed independent obligations. In construing the instrument, the more closely the obligations are linked to the rights, the easier it will be to construe the instrument as granting merely qualified rights. The question always must be one of the intention of the parties as gathered from the instrument as a whole.[16]
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> …
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> In such cases the rule is really a rule of 'all or none', an inelegant but convenient expression that may be used for brevity. A burden that has been made a condition of the benefit, or is annexed to property, simply passes with it: if you take the benefit or the property you must take it as it stands, with all its appendages, good or bad.[17]

The above principle – which for convenience might be referred to as "a qualified right" – has been applied in Canada in *Silver Butte Resources Ltd. v. Esso Resources Canada Ltd*.[18] and *Wentworth Condominium Corp. No. 12 v. Wentworth Condominium Corp. No. 59*.[19]

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[14] [1977] Ch. 106, at 292 and 310, [1977] 3 All E.R. 129.
[15] Ibid, at page 281.
[16] Ibid, at page 287.
[17] Ibid, at page 291.
[18] [1994] B.C.J. No. 1125, 19 B.L.R. (2d) 299, 48 A.C.W.S. (3d) 195.

British Columbia – Obligation to Reforest

In British Columbia, the obligation to reforest runs with the forest tenure by operation of statute. Under s. 54.6(1)(c) of the *Forest Act* (British Columbia), the purchaser of a forest tenure agreement "becomes liable in the person's capacity as the holder of the agreement…to perform all obligations under the agreement [including the obligation to reforest], including but not limited to obligations accrued or accruing as of the date of completion and still outstanding as of that date".[20] Thus, in British Columbia the answer to one part of the Supreme Court's first question is yes: the obligation to reforest runs with the forest tenure.

However, in the very same section (s. 54.6(2)), the *Forest Act* provides that the vendor *remains* jointly and severally liable with the purchaser for the liabilities that accrued or were accruing as of the date of sale. This goes to the other part of the Supreme Court's first question, which is discussed below.

Alberta / Daishowa – Obligation to Reforest

Daishowa's forest tenure was in Alberta. The applicable statutory regime there provided that any transfer of a forest tenure was an "unconditional assignment of the *entire interest therein* of the assignor"[21] (emphasis added). What is to be taken from this statutory language? Does it mean that the burden of the reforestation liabilities automatically runs with the forest tenure transferred?

The Alberta government apparently interpreted this language to mean that "a forest tenure cannot be assigned unless the assignee assumes the silviculture liability associated with the forest tenure".[22] But what is meant by that statement? Is it merely reflecting what the statute says? Whether the obligation to reforest "runs with the forest tenure" (and in what manner) would seem to be a question of law, which any court should be free to decide.[23]

If the reforestation obligation did not run with the forest tenure by statute, could the principle of a qualified right apply? As noted in the excerpt from *Tito v. Waddell (No. 2)*, this is a question of construction of the agreement containing the grant of the right. In Daishowa's case, the right to cut and remove timber was granted in s. 7(1) of the Forest Management Agreement dated December 19, 1996. That provision was itself stated to be "Subject to all the terms and conditions of this Agreement", including the obligation to reforest. One cannot think of a closer "link" between the obligation and the right, such that the right to cut and remove timber was a qualified right *ab initio*.

If this is so, the principles described in *Tito v. Waddell (No. 2)* should apply and the obligation to reforest would run with the forest tenure. In other words, the obligation to reforest was:

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[19] [2007] O.J. No. 2741 (OSCJ). A second exception was also expressed in *Tito v. Waddell (No. 2)*, which has been referred to as the "pure principle of benefit and burden". This second exception was later clarified (narrowed) by the House of Lords in *Rhone v. Stephens*, [1994] 2 A.C. 310, where it was said that for this second exception to apply "the condition must be relevant to the exercise of the right". This second exception is not explored further in this note.

[20] S. 29.1 of the *Forest and Range Practices Act* (British Columbia) allows for a transfer of the reforestation obligations *where approved of by the Minster*. However, the province has historically said that this *discretionary* provision has no application where the tenure itself is transferred. In the latter event, s. 54.6 of the *Forest Act* is the governing or paramount provision. In any event, unless the Minister exercises his discretion, s. 54.6 clearly governs.

[21] S. 163(1) of the *Timber Management Regulation* (Alberta); trial judgment, paragraph 3.

[22] Trial judgment, paragraph 3.

[23] *Teck Corp. v. British Columbia*, 2004 BCCA 514 (FCA), at paragraph 36.

> …an intrinsic part of the right; you take the right as it stands, and you cannot pick out the good and reject the bad. In such cases it is not only the original grantee who is bound by the burden; his successors in title are unable to take the right without also assuming the burden. The benefit and the burden have been annexed to each other ab initio…
>
> …the burdens are as binding as if the taker of the benefit or estate had executed the instrument…take the benefit, and at once the burdens bind you…
>
> A burden that has been made a condition of the benefit, or is annexed to property, simply passes with it: if you take the benefit or the property you must take it as it stands, with all its appendages, good or bad…

Perhaps the foregoing principles together explain (or provide an underlying rationale for) the statements made by both the Tax Court and the Court of Appeal. For example, at paragraph 45 the Tax Court judge (Miller J.) said the following:

> As has been made clear in Alberta, the forest tenures could not be transferred without the Purchaser assuming the reforestation liability. It is part and parcel of the forest tenures: you own the forest tenures and you are therefore responsible for the reforestation. It makes no commercial sense to me to view the transaction as payment of the reforestation costs by the transfer of the forest tenures.

At the Court of Appeal, Nadon J.A. for the majority said the following:

> The reforestation liability, by law, passes with the ownership of the tenure itself.[24]
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> [The] Alberta legislation requires that the owner of the forest tenure and of the reforestation liability associated with that tenure be the same.[25]

And finally, the dissenting judge at the Federal Court of Appeal (Manville J.A.) said the following:

> I am rather of the view that the reforestation liabilities form an integral part of the forest tenures, and though they affect the value of the tenures, they are not a separate consideration of the sale transactions involving the tenures…[26]
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> …whether the reforestation liabilities pass automatically from the vendor to the purchasers of the forest tenures by operation of the legislation or as a result of the conditions attached to the required

[24] At paragraph 89.
[25] At paragraph 99.
[26] At paragraph 45.

> consent of the Albertan authorities is of no consequence; in either case the reforestation liabilities are inextricably linked to the forest tenures and form an integral part thereof.[27]

That reforestation obligations run with (are annexed to) the forest tenures, either by statute or as part of a qualified right, should come as no surprise. Governments are right to link the burden with the benefit in such cases. The same is true in the mining industry. One would not expect to see the grant of such an important liberty – the right to extract valuable resources from the land – without a corresponding obligation to fully repair any damage caused in doing so. The obligation to repair is annexed to the right granted, such that the right granted is itself (or amounts to) a qualified right.

Was the vendor relieved of a liability?

As mentioned in the opening, this was the other part of the Supreme Court's first question. As previously noted, in British Columbia the answer seems clear by statute. Under s. 54.6(2) of the *Forest Act*, the vendor remains jointly and severally liable with the purchaser for the reforestation liabilities that accrued or were accruing as of the date of sale. In other words, the answer to the other part of the Supreme Court's first question, at least in British Columbia, would be no: the vendor has not been relieved of a liability.

In Daishowa's case (Alberta), the Alberta government's position (policy) was not to pursue vendors for any continuing liability following the transfer of the forest tenure.[28] In this sense, the vendor might be viewed as having been relieved of a liability. However, the result in law could well be different.[29]

What if the sale agreement contains an indemnity such that the vendor is to be indemnified for any liability that might later be enforced against the vendor? Has the vendor been relieved of a liability at the time of the sale? One might reasonably say no, the vendor has not (yet) been relieved of a liability.

Does it matter that the parties agreed?

The Supreme Court's second question was whether it makes any difference that the parties agreed to a specific amount for the future reforestation liability.

Again, consider British Columbia. Assume the parties agree at the time of sale that the future obligation to reforest may be estimated at $5 million. This estimates the future cost of actually planting the new trees. As observed above, the purchaser *cannot* escape that obligation (to replant) – it runs with the forest tenure. In this sense, the estimated amount of that future obligation certainly goes to the negotiated value of forest tenure itself. But does it *also* mean that the parties have agreed that the vendor has been "relieved of a liability" in that same amount?

Let's assume, for the moment, that the agreed number for the reforestation liabilities does represent the agreed amount by which "the vendor's obligation has been relieved". We then have a case where

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[27] At paragraph 136.

[28] Trial judgment, paragraph 3.

[29] Under s. 122.1(1)(e) of Alberta's *Timber Management Regulation* a "timber disposition holder" is inclusive of a former disposition holder in described circumstances. This meant that Daishowa could well have been secondarily liable for reforestation obligations arising before the assignment of its forest tenure. This could place Daishowa in the same position as a vendor in British Columbia.

the obligation ran with the forest tenure (one part of the Supreme Court's first question), but the vendor has *also* been relieved of real economic obligation (the other part of the Supreme Court's first question). What then?

Possible Two-Part Answer

These are difficult concepts to be sure. However, perhaps the answer comes in two parts as well.

1. If the obligation to reforest runs with the forest tenure (i.e., "the reforestation liability, by law, passes with the ownership of the tenure itself"), then the performance of that obligation by the purchaser should not constitute a separate contractual obligation flowing from the purchaser to the vendor. Rather, the obligation is simply "part and parcel of the forest tenures" acquired. A contractual obligation is the legal essence of "consideration".[30] If the performance of the obligation by the purchaser cannot constitute a separate contractual obligation of the purchaser (in favor of the vendor), then there should be no additional consideration flowing to the vendor. No additional proceeds of disposition.[31] In other words, a purchaser cannot further promise to do something that it is already bound to do. If there is no further promise, there is no additional consideration - and no additional proceeds.

2. This, however, is not the end of the matter. While the obligation to reforest might not be additional proceeds of sale, we have assumed (above) that the vendor *has* been relieved of a real economic obligation. The *Income Tax Act* (Canada) (the "Act") addresses such a situation in s. 80.[32] Where a taxpayer is relieved of a "commercial obligation",[33] appropriate (and sometimes very complex) tax consequences flow. However, the short answer here is that no tax consequences flow to the vendor. The reason is that the economic obligation relieved is not a "commercial obligation" as defined in s. 80(1) of the Act. The economic obligation, although very real, is still a contingent obligation for tax purposes. This means that it is not a "debt obligation" in respect of which interest (if interest had been payable) "would have been deductible" under the Act. This, in turn, means that the obligation is not a "commercial obligation" as defined under s. 80(1) of the Act.[34]

One would think the foregoing two-part answer should not be objectionable in principle, as the vendor has had no cost recognition for the obligation to reforest that has been relieved – either before the sale or as part of the sale. Such a burden is only recognized for tax purposes at the time it becomes an *actual liability incurred*: whether this occurs before or after the forest tenure is sold.[35] Such an actual liability incurred would be a commercial obligation at that time. Any relief from *that* liability should attract appropriate consequences through the application of s. 80 and related provisions of the Act.[36]

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[30] Fridman, supra note 9 at 81.
[31] Whether this principle could extent to other circumstances is beyond the scope of this short note.
[32] And possibly s. 9 if the liabilities are on income account.
[33] As defined in s. 80(1) of the Act.
[34] S. 9 should also not be engaged as the obligation relieved was not an actual liability incurred.
[35] *Northwood Pulp and Timber Limited v. The Queen, supra note 7; McLarty v. R.*, 2008 SCC 26 (S.C.C.); *Winter v. Inland Revenue Commissioners* (1961), [1963] A.C. 235 (H.L.).
[36] This would also include an examination of whether relief of the actual liability incurred is considered ordinary income under s.9 (i.e., if the liability incurred was on income account).