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Tax Treatment of Contingent Liabilities in an Asset Sale: Canada's *Daishowa v. The Queen*

by
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Background

In *Daishowa-Marubeni International Ltd. v. The Queen*,[2] 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.[3] The original agreement (representing the forest tenure) granted to a predecessor of Daishowa[4] the right to cut or remove timber from the defined lands, but that right was subject to an obligation on the predecessor to submit reforestation plans and reforest all lands cut over by it.[5]

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.[6]

In filing its tax return for 1999, Daishowa did not recognize any taxable proceeds of disposition in respect of the $11,296,225 of reforestation liabilities. It also had not deducted (in computing its income) any portion of those reforestation liabilities – 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.[7]

The Canada Revenue Agency (CRA) subsequently reassessed Daishowa to add the full $11,296,225 of estimated reforestation liabilities to Daishowa's taxable 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.[8]

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[2] *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) (*Daishowa*).

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

[4] Predecessor by amalgamation.

[5] S. 7(1) of the 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".

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

[7] 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).

[8] 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.

The Double Tax Problem

Many practitioners in Canada have trouble accepting the Court of Appeal's (majority) decision.[9] The basic problem is clear double taxation. In a statute as complex as the *Income Tax Act* (Canada) (the "Act"), cases of clear double taxation are not common – and certainly are not expected in a straight-forward asset sale. Double tax arises in *Daishowa* because the vendor was treated as having received taxable proceeds of disposition (consideration) in respect of an economic obligation for which Daishowa had no deduction or cost for tax purposes. This strikes many practitioners as wrong in principle, if not in law.

The Supreme Court's Tax Questions

New hope appeared when the Supreme Court granted leave to appeal the Court of Appeal's decision. Particularly encouraging were the tax questions that will frame the debate:

> 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?[10]

Possible Short Answers?

These are difficult questions to be sure, and opinions may differ as to their answer. However, what follows is one brief attempt.

<u>First Tax Question</u>

Are the reforestation liabilities included in Daishowa's taxable proceeds of disposition because they relieve the vendor of a liability or are they integral to and run with the forest tenures?

The answer should be no: they are not included in taxable proceeds because they are integral to and run with the forest tenures. All four judges in the courts below essentially said – and for good reason[11] – that the reforestation liabilities were integral or otherwise ran with the forest tenures. For example, at paragraph 45 the Tax Court judge (Miller J.) said the following:

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[9] 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.

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

[11] The reasons are explored in a separate note to appear in another publication.

> 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.[12]
>
> [The] Alberta legislation requires that the owner of the forest tenure and of the reforestation liability associated with that tenure be the same.[13]

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…[14]
>
> …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 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.[15]

If the obligation to reforest simply runs with the forest tenure, then it should follow that the performance of this obligation by the purchaser does not constitute a further contractual promise from the purchaser to the vendor. A contractual obligation (promise) is the legal essence of consideration.[16] If a purchaser cannot (further) promise to do something that it is already bound to do (because when it owns the property the obligation is automatic), there should be no separate and additional consideration to the vendor. No additional taxable proceeds.

But this raises a subsidiary question. How can you accept the above answer if the vendor has *also* been "relieved of a real economic obligation" at the same time? The answer may be this: If the vendor was relieved of any liability in *Daishowa*, it was the province (a third party) and *not* the purchaser who did so. In any event, being relieved of a liability ordinarily has important tax consequences through the "debt-forgiveness" provisions of the Act (section 80, or possibly section 9 if the liabilities relieved are on

[12] At paragraph 89.
[13] At paragraph 99.
[14] At paragraph 45.
[15] At paragraph 136.
[16] Fridman, *The Law of Contract*, 6th ed. (2011) at 81.

income account). But here those provisions were simply not engaged because the liabilities relieved were *contingent* liabilities; they were not yet *actual liabilities incurred* within the meaning determined by the Supreme Court (in other cases). Being relieved of such liabilities here was a tax nothing; but that result seems quite appropriate because the vendor also has had no previous deduction or cost for these liabilities either.

Second Tax Question

Does it make any difference that the parties agreed to a specific amount of the future reforestation liability?

The answer should be no, if this question goes to whether there was additional taxable proceeds to the vendor. However, the answer to the question should be yes if one is simply talking about the negotiated value of the forest tenures sold. That is, the agreed amount of the future reforestation liabilities was certainly one factor in arriving at the overall fair market value of the forest tenures (determined on a future cash flow basis).[17]

Answering the two tax questions in this manner would avoid clear double taxation, and would be based on the principles found in both the existing case law and the Act.

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[17] See Joseph Frankovic, supra note 9.