Current Cases

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SUPREME COURT OF CANADA

SUPREME COURT WEIGHS IN ON AGE-OLD QUESTION: IF A TREE FALLS IN THE FOREST . . .

Daishowa-Marubeni International Ltd. v. Canada
2013 SCC 29

KEYWORDS: CONTINGENT LIABILITIES ■ SUPREME COURT OF CANADA ■ DISPOSITIONS ■ LIABILITIES

> If a tree falls in the forest and you are not around to replant it, how does it affect your taxes?[1]

This was the question posed by Rothstein J of the Supreme Court of Canada in the opening paragraph of his judgment on behalf of a unanimous court in the *Daishowa* case.

Rothstein J's witticism refers to the particular facts in *Daishowa*. More broadly, this case raises an important question in the context of a business acquisition: When a liability of a vendor associated with the business is not recognized for tax purposes, does the assumption of that liability by a purchaser increase the proceeds of disposition? If it does, there is a windfall for the public purse, since taxes are levied on phantom income or gains. This was the surprising position advocated by the

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1 *Daishowa-Marubeni International Ltd. v. Canada*, 2013 SCC 29, at paragraph 1. Intervenors included the government of Alberta, Tolko Industries Ltd., International Forest Products Ltd., West Fraser Timber Co. Ltd., Canfor Corporation, and the Canadian Association of Petroleum Producers.

Canada Revenue Agency (CRA) in *Daishowa*, and it was the unfortunate result of the decisions of the Tax Court of Canada[2] and the Federal Court of Appeal.[3] Thankfully, that result was overturned by the Supreme Court of Canada.

The assumption by a purchaser of a crystallized liability of a vendor is generally considered to constitute part of the proceeds of disposition of the property. However, prior to *Daishowa*, whether this principle extended to contingent liabilities (or any other liabilities of the vendor not recognized for tax purposes) was not clear.

While the liabilities at issue in *Daishowa* were contingent liabilities, that did not factor into the Supreme Court's decision. Rather, the court's basis for finding that the assumption of liabilities did not form part of the proceeds of disposition was that the liabilities (whether contingent or absolute) were "embedded" in the sold property and only served to depress the value of that property.

Accordingly, it remains to be seen whether courts can and will prevent the CRA from taxing phantom income or gains on the assumption of contingent liabilities (or any other liability not recognized for tax purposes) where such assumption falls outside the principles enunciated by the Supreme Court in *Daishowa*, or whether Parliament will enact legislation to foreclose such an unfair result.

Facts

Prior to the dispositions at issue, the taxpayer, Daishowa-Marubeni International Ltd. ("DMI"), carried on the business of harvesting logs and manufacturing finished timber. In connection with carrying on that business, DMI held two forest tenures that allowed it to cut and remove timber from Alberta-owned land. The regulatory regime under which tenures were granted obliged DMI to undertake certain reforestation or silviculture activities after it harvested the timber. The reforestation obligations would generally take 8 to 14 years to satisfy.

DMI sold the two forest tenures in separate transactions in 1999 and 2000, respectively. As required under Alberta law, DMI sought and received Alberta's consent to the assignment of the forest tenures.[4] As a known precondition to such consent, the associated reforestation obligations were required to be assumed by the purchaser.[5] Accordingly, in both of the subject transactions, the purchaser assumed those obligations.

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

3 *Daishowa-Marubeni International Ltd. v. The Queen*, 2011 FCA 267.

4 Forests Act, RSA 1980, c. F-16, as amended, sections 16(3) and 28(2); and the Timber Management Regulation, Alberta Reg. 60/1973, section 154.

5 As indicated by Miller J at the Tax Court of Canada, supra note 2, at paragraph 3, "It was the position of the Alberta Department of Sustainable Resource Development that, based on section 163 of the *Timber Management Regulation*, a forest tenure cannot be assigned unless the assignee assumes the silviculture liability associated with the forest tenure." Section 163 of the Timber Management Regulation provides, "Every assignment made shall be an unconditional assignment of the entire interest therein of the assignor, but the assignor may also be one of the assignees." The government of Alberta, an intervenor in the proceedings, informed the

In filing its tax returns for the respective years of sale, DMI did not include in its income any amount in respect of the purchasers' assumption of the reforestation obligations. The minister of national revenue reassessed DMI on the basis that it was required to include an amount equal to the estimated cost of the reforestation obligations assumed by the purchasers in its proceeds of disposition from the sale of the forest tenures.

THE ISSUE

Competing analogies presented at the Supreme Court by the minister and DMI aptly framed the nature of the issue before the court. The minister submitted that a forest tenure with its corresponding reforestation obligations is analogous to property encumbered by a mortgage. Accordingly, the purchaser's assumption of reforestation obligations, like the assumption of a mortgage, formed part of the sale price and was required to be included in the vendor's proceeds of disposition.

By contrast, DMI argued that a forest tenure with its corresponding reforestation obligations is more analogous to property that is in need of repair. If that property is sold, the purchaser's assumption of the cost of repairs does not form an additional part of the sale price of the property.

Lower-Court Decisions

The Tax Court of Canada agreed with the minister that the assumption of the reforestation obligations was part of the consideration given by the purchaser for the forest tenures. The Tax Court indicated that it would be difficult to find otherwise given the admission by DMI that had the purchaser not assumed the obligations, the consideration paid by the purchaser would have increased.[6] While this admission may be hypothetically correct, its wording was not helpful to DMI's case since it implicitly accepts that the purchaser could have left the liability behind. Unfortunately, the Tax Court did not seem to fully appreciate the admission in the context of Alberta's regulatory regime—that the admission was no more than "had the purchaser not assumed the obligations *(had it been able to)*, the consideration paid to the purchaser would have increased"—which is as harmless and obvious a fact as an admission by a vendor that it would have received more consideration for a property had the property not been in need of repair.

However, the Tax Court did not agree with the minister that the expected costs should be the value of the assumed obligations. Instead, the Tax Court applied a steep discount to the expected costs (specifically the expected long-term costs) in arriving at a materially lower figure.

Supreme Court that its position is that, upon assignment of a forest tenure, the purchaser is solely responsible for carrying out the reforestation activities and the vendor is relieved of any liability for satisfying the reforestation obligations. *Daishowa*, supra note 1, at paragraph 10.

6 *Daishowa*, supra note 2, at paragraph 24.

A majority of the Federal Court of Appeal agreed with the Tax Court that the assumption of the reforestation obligations was part of the consideration given by the purchaser for the forest tenures.[7] However, the majority disagreed with the valuation method of the Tax Court.[8] The dissenting judgment at the Federal Court of Appeal would have allowed DMI's appeal for effectively the same reasons that were subsequently expressed by the Supreme Court.[9]

Supreme Court Decision

With respect to the competing analogies, the Supreme Court agreed with DMI and held that the reforestation obligations represented a future cost embedded in the forest tenure that served to depress the tenure's value at the time of sale. The key fact for the court in coming to that conclusion was that the obligations could not be severed from the tenure. A purchaser of the tenure had no choice but to assume the obligations and take into account the costs of carrying out the reforestation obligations when valuing the tenure.

The court addressed the minister's analogy by observing that a mortgage does not affect the value of the property it encumbers. A vendor of a mortgaged property can sell the property for fair market value and then pay off the mortgage. Conversely, "the reforestation obligations were not a distinct existing debt, like a mortgage, but were embedded in the tenure so as to be a future cost associated with ownership of the tenure."[10]

Thus, the court concluded that if a tree falls in the forest and you are not around to replant it, you are not required to include the anticipated cost of the replanting in your proceeds of disposition.

Discussion

The principles articulated by the Supreme Court in *Daishowa* set parameters on whether the assumption of a vendor's liability by a purchaser will constitute part of the sale price of the property sold and, therefore, part of the proceeds of disposition of the property. The critical factor for the Supreme Court in *Daishowa* was that rather than being a distinct liability that is assumed, the reforestation obligations at issue were "embedded" in the relevant forest tenures by virtue of Alberta's regulatory regime, which prevents a vendor from disposing of forest tenures unless the purchaser assumes the reforestation obligations. Accordingly, the reforestation obligations were more akin to damage to property that depresses its value than to a free-standing liability.

7 *Daishowa*, supra note 3, at paragraphs 46-51, per Nadon JA.

8 Ibid., at 58, per Nadon JA.

9 Ibid., at 128, per Mainville JA.

10 *Daishowa*, supra note 1, at paragraph 35.

Although the decision is helpful to DMI and others operating under similar regulatory regimes, a number of questions remain for other taxpayers. What does it mean for an obligation to be "embedded" in property? How does one distinguish between a "future cost embedded" in property and a separate obligation of a vendor that, if assumed by the purchaser, must be included in the proceeds of disposition of the property?

The Supreme Court expressly stated, in obiter, that it

> would certainly not foreclose the possibility that obligations associated with a property right could be embedded in that property right without there being a statute, regulation or government policy that expressly restricts a vendor from selling the property right without assigning those obligations to the purchaser.[11]

However, the court did not provide examples or guidance as to when this might be the case (although it is notable that the court's obiter dictum was in response to an example provided by an intervenor related to the acquisition of property rights associated with the mining of gas and oil, and whether the statutory obligations to reclaim mined land may be so physically connected to the process of mining itself that the obligations cannot be separated from the property right).[12]

The court was of the view that the reforestation obligations were embedded in the forest tenures "by reason of the policy and practice of Alberta,"[13] as opposed to a statutory requirement. One may wonder whether the court's analysis could be extended to matters of market practice, particularly where it is impractical for the vendor to maintain the liability and/or it is important from the purchaser's perspective (for example, because of goodwill considerations) that the purchaser assume the liability.

Asymmetry with "Non-Recognized" Liabilities

While the reforestation obligations were a contingent liability, that factor did not play a role in the Supreme Court's judgment, apart from its observation regarding the asymmetrical tax treatment accorded to such liabilities. The Supreme Court's view was that the assumption of the reforestation obligations was not to be included in DMI's proceeds of disposition, regardless whether the liability was contingent or absolute. In this connection, the court observed that DMI's argument that the reforestation obligations should not be included in its proceeds of disposition because they were a "contingent liability" may have caused confusion in the lower courts because it implicitly accepts that the cost of reforestation is a liability of DMI that is

11 Ibid., at paragraph 36.

12 Ibid.

13 Ibid., at paragraph 30.

not embedded in the forest tenure and the assumption of such cost would constitute proceeds of disposition but for the contingent nature of the liability.[14]

While the CRA's view is that the fair market value of contingent liabilities assumed by a purchaser is required to be included in the vendor's proceeds of disposition, the CRA is also of the view that the purchaser is prohibited from including any amount of the liability in the cost of the applicable asset until the contingency is met.[15] The absurd consequence that can result from this position was highlighted by the Supreme Court by the following example related to one of the transactions:

> Under the Minister's approach, the sale of the [forest tenure] to Tolko would have resulted in taxable proceeds of $31 million for DMI ($20 million received plus $11 million in assumed reforestation obligations). However, Tolko's adjusted cost base would be $20 million (just the amount paid). The Minister's asymmetrical approach means that if Tolko sold the forest tenure to a new purchaser the very next day, Tolko would be assessed taxable proceeds of $31 million (the amount received plus the assumption of the future reforestation costs). That is, Tolko would be assessed $11 million of taxable income, despite in no way receiving such additional income.[16]

However, the absurd consequence that can result from the CRA's position can also be illustrated through the lens of the original vendor, as suggested by the authors of a previous case comment on the Federal Court of Appeal decision:

> 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* [at the Federal Court of Appeal], 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 [also] on an additional income gain of $500 from selling the resource property.[17]

The absurd consequences were avoided in *Daishowa*—and then only at the Supreme Court of Canada—because of that court's finding that the liabilities were embedded in the applicable asset. But what if the liabilities are not considered to be embedded in the applicable asset? While the Supreme Court did not address that situation, it did

14 Ibid., at paragraph 40.

15 See, for example, CRA document no. 2002-0164607, October 23, 2002.

16 *Daishowa*, supra note 1, at paragraph 42.

17 Michael Colborne and Steve Suarez, "Timber! Consequences of Assuming Reforestation Obligations," Current Cases feature (2012) 60:1 *Canadian Tax Journal* 137-43, at 143.

observe that it has recognized in the past that a taxpayer (including a vendor) does not incur an expense for tax purposes if the liability is contingent,[18] while a purchaser may not include a liability in his capital cost if that liability is contingent.[19]

Accordingly, unless taxpayers fit within the principles established by *Daishowa*, there remains the risk that the CRA will seek to assess tax on phantom income or gains on the assumption of a contingent liability (or any other liability not recognized for tax purposes).

It is a common occurrence for the Department of Finance to release legislation in response to a perceived gap created (or brought to light) by a court decision favouring a taxpayer. How refreshing it would be for Finance to release legislation in response to this court decision that, while favouring the taxpayer, keeps the door open for the CRA, in certain circumstances, to assess tax on phantom income and gains as it attempted to do in *Daishowa*.[20]

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FEDERAL COURT OF APPEAL

CAPITAL GAIN VERSUS INCOME: FLYING INTO FOG

CAE Inc. v. Canada
2013 FCA 92

KEYWORDS: CAPITAL GAINS ■ INCOME ■ INVENTORY ■ OPTIONS ■ CAPITAL COST ALLOWANCE

The recent decision of the Federal Court of Appeal in *CAE Inc. v. Canada*[21] raises interesting questions about the distinction between capital property and property that is held in inventory, and the application of the change-of-use rules to such property.

FACTS

CAE Inc. ("CAE") was in the business of manufacturing flight simulators either (1) for sale or (2) for lease (with or without the provision of flight training services) ("the leasing and training component"). At issue was the characterization, for tax

18 *Canada v. McLarty*, 2008 SCC 26, at paragraphs 14-16.

19 *Mandel v. The Queen*, [1980] 1 SCR 318.

20 Such legislation should provide that the value of any assumed liability shall be included in the proceeds of disposition only to the extent that the liability is recognized for income tax purposes (for example, that the vendor is entitled to claim a deduction in respect of the liability or add it to the cost of an asset).

21 2013 FCA 92.