



The Tax Consequences of Estimating assumed obligations: The Daishowa-Marubeni Case

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On September 23, 2011, the Federal Court of Appeal (the FCA) released the highly anticipated decision in [Daishowa-Marubeni International Ltd. v. The Queen](#). The decision will be of particular interest to every mining, energy and forestry company that has bought or sold assets in circumstances where reclamation or reforestation obligations were assumed by the purchaser as part of the sale. As a result of the FCA's decision, the assumption of these obligations as part of a purchase and sale of resource property may give rise to additional proceeds of disposition.

In this case, the corporate taxpayer (Daishowa) carried on a forestry business through three divisions. In 1999, Daishowa decided to sell two of the divisions, which were engaged in the business of harvesting logs and manufacturing finished timber and other goods.

Tax Court of Canada

The Tax Court of Canada (the TCC) considered the issues with respect to the sale of each division to be the same, and only addressed the sale of the High Level Division to Tolko Industries Ltd. (Tolko). As further discussed below, this aspect of the TCC's decision was undermined on the appeal, as the FCA referred the determination of the issues in respect of the sale of the second division, being the sale of the Brewster Division, back to the TCC for fuller consideration.

As part of each of the divisions, Daishowa held timber rights, which gave rise to certain reforestation liabilities. Daishowa accepted Tolko's bid of \$180,000,000 plus the estimated value of the net working capital less the estimated amount of the long-term reforestation liability assumed by Tolko. Consequently, the Purchase and Sale Agreement provided the following: a purchase price of \$169,000,000 for the assets; the net working capital (as adjusted); and the assumption of the \$11,000,000 reforestation obligations, plus or minus "any difference between a preliminary and a final estimate" of the reforestation obligations. Since the reforestation statement prepared by the accountants ultimately determined the amount of the reforestation obligations to be \$296,225 more than the original estimate of \$11,000,000, the total purchase price was decreased by an equivalent amount and Daishowa paid this difference to Tolko.

The TCC held that the assumption of the reforestation obligations constituted additional proceeds of disposition of "timber resource property", which is treated as depreciable property for purposes of the Income Tax Act (Canada) (the Tax Act). The TCC noted that Daishowa admitted that the purchase price would have been greater if Tolko had not assumed the reforestation obligation. This admission would plague Daishowa throughout the trial and on the appeal. Although the reforestation obligation arose as soon as the trees were cut, the TCC acknowledged that the reforestation costs would not be known until

the costs were actually incurred. The TCC concluded that the \$11,000,000 assigned to the reforestation obligations did not represent an agreement between the parties that this was the actual value of the liability. Rather, the TCC concluded that the value of the assumed obligations consisted of a current reforestation liability of \$2,057,498 and a discounted portion of the long-term liabilities of \$9,238,727. For this purpose, the TCC assigned a discount of 80% to the long-term liabilities, with the result that a total of \$3,905,244 was added to the proceeds received by Daishowa on the sale of the High Level Division. It is not at all clear how the TCC arrived at the 80% discount and this became one of the issues before the FCA. Finally, the TCC denied Daishowa's argument that if any portion of the reforestation obligation is included as additional proceeds of disposition of the High Level Division, then it should be entitled to an offsetting deduction because of its payment to Tolko of a portion of the timber rights for Tolko agreeing to assume the reforestation obligation.

Federal Court of Appeal

The FCA considered several issues, but the most pertinent related to the treatment of the reforestation obligations as additional proceeds of disposition. In particular, the key issues were: (i) did the TCC err in treating the reforestation obligations as additional proceeds; (ii) was the TCC correct in assigning a discount of 80% to the long term reforestation liability; (iii) was Daishowa entitled to a deduction for the portion of the timber rights that it claims were consideration for the purchaser assuming the reforestation obligation; and (iv) finally, is any portion of the \$11,000,000 attributable to the sale of goodwill by Daishowa?

The FCA noted that there is no debate between the parties, or at law, that the assumption of a liability by a purchaser may constitute additional consideration. In this respect, the FCA reiterated the finding of fact admitted by Daishowa, namely that Daishowa would have received additional cash or other consideration if the purchaser failed to assume the reforestation obligations. The FCA rejected Daishowa's argument, and the TCC's decision, that the \$11,000,000 was simply an estimate and not an agreed upon value for purposes of determining an amount in respect of the assumption of the reforestation obligation. The FCA held that, based on an interpretation of the contract regarding the sale of the High Level Division, the parties had agreed to the value of the reforestation liability. Accordingly, the FCA overturned the findings of the TCC and held that the entire \$11,000,000 should be included in Daishowa's proceeds of disposition.

Whether the reforestation was a contingent obligation, as Daishowa argued, or an absolute obligation, was irrelevant to the FCA. According to the FCA, the issue in circumstances of this kind is whether the obligation assumed can be valued. For example, where a purchaser assumes all future tort liability arising from the vendor's business, no portion of any damages that arise after the sale would constitute additional proceeds of disposition if the parties attributed no value to this assumption of liability. This is an interesting finding because, although a reforestation or reclamation obligation may arise as soon as the purchaser cuts trees or enters land to drill for oil, such is not the case with respect to a tort liability, which only arises when the injury is suffered. As a result, if the parties do not assign a value to the reforestation or reclamation obligations, then presumably there is no amount to include in the vendor's proceeds of disposition. The FCA does not address this distinction and consequently it will likely be litigated another day, and possibly addressed when the TCC reconsiders the sale of the Brewster Division.

The FCA agreed with the TCC that Daishowa is not entitled to a deduction from income to offset the additional proceeds of disposition that are included in its income. In this respect, the FCA noted that the reforestation liability was of a capital nature and, accordingly, a deduction is not allowed under the Tax Act. The FCA also agreed with the TCC's decision that the entirety of the amount relating to the assumption of the reforestation obligation should be allocated to "timber resource property" and no portion should be allocated to goodwill.

The FCA also found that the TCC's reasons for judgment did not adequately consider the sale of the second division. In particular, the FCA held that the TCC failed to address the factual differences between the sale of the High Level Division and the sale of the Brewster Division. Accordingly, with respect to the sale of the Brewster Division, the FCA allowed Daishowa's appeal and returned the matter to the TCC for reconsideration of the issues in light of the FCA's reasons. This aspect of the FCA's decision emphasizes

the weight that the facts of the particular circumstances, such as the wording of the agreement between the parties, are to be given in determining the taxation of assumed obligations.

Mainville J.A. of the FCA issued a dissenting judgment, which stated that the assumption of the reforestation liabilities by the purchasers should not be considered to be a separate and distinct consideration whose value has to be added to Daishowa's proceeds of disposition. Rather, Mainville J.A. noted that the reforestation liabilities are an integral part of the timber rights, and while such liabilities affect the value of the timber rights, they are not a separate consideration. In other words, the fact that the purchasers assumed the reforestation liability reduced the value of the timber resource properties being sold, and Daishowa received a lower price as a result. In addition, Mainville J.A. stated that the Government's approach means that parties that do not identify the value of the reforestation liabilities may not have an additional amount included in the proceeds of disposition, whereas parties that are transparent and assign a value to such liabilities may trigger additional proceeds of disposition. However, Mainville J.A. concluded in his dissenting judgment that whether the parties have agreed to the value of the reforestation liabilities should not determine whether or not these liabilities form part of the proceeds of disposition.

The decision of the FCA is of key importance in the mining, forestry, and oil and gas context, where the assumption of reforestation and reclamation liabilities is part and parcel of the sale of properties. In addition, this case can also have a broader impact, for example with respect to any sale of a business where pension, severance and other obligations are assumed by the purchaser and a value is assigned to the assumption of those obligations. The decision of the FCA was based in part on the wording of the contract between the parties, and also certain admissions made by Daishowa during the litigation process. Accordingly, taxpayers should consider this case and its implications when drafting purchase and sale agreements, as well as with respect to sale transactions that have already occurred. Further, this case may create additional complications for purchasers who assume certain obligations and an amount is assigned to such obligations as part of the transaction. Presumably, based on the FCA's decision, the assumption of such obligations may form additional cost of the properties acquired, although the timing of the addition to the cost of the properties is unclear. At this time, it is uncertain whether leave will be sought to appeal the decision of the FCA to the Supreme Court of Canada, or whether leave to appeal would be granted

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