
Supreme Court of Canada ruling in Daishowa-Marubeni: Tax treatment of reforestation obligations on sale of forestry assets

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In brief

The Supreme Court of Canada (SCC) ruled in favour of the taxpayer in **Daishowa-Marubeni International Ltd. v. The Queen** (DMI). The SCC released its unanimous decision today.

The decision held that no amount was includible in DMI's sale proceeds for forest tenures (i.e. the right to harvest timber on land) as a result of two purchasers having assumed DMI's future obligations to reforest the land on which it had previously harvested trees. This is an important and positive decision for the forestry, mining, pipeline and petroleum industries, where it is common that a purchaser of forestry or oil producing assets must assume reforestation or reclamation obligations. The SCC held that the future costs were 'embedded' in the transferred assets, were not distinct existing liabilities and thus were not includible in the sale proceeds.

In detail

Background

Where a 'hard' liability of a seller (e.g. a mortgage debt or accounts payable) is assumed by a buyer on an asset sale, it is clear that the seller must include the amount of the assumed liability in its sale proceeds for tax purposes.

Whether this is also the case where the assumed seller 'liability' is a contingent or future obligation had not previously been addressed by the SCC.

The established Canada Revenue Agency (CRA) position has been that the seller must include the fair market 'value' of an assumed contingent liability in the sale proceeds, while at the same time taking the position that the buyer would not be able to include this amount in its cost for the purchased assets until the amount of the liability became completely certain.

In the **DMI** case, the CRA took the position that on the sale of two of its timber mills, DMI must treat as part of its sale

proceeds the accounting reserve for estimated future reforestation obligations that was required under accounting principles to be recorded on its balance sheet. DMI challenged this position.

DMI was not successful at the Tax Court of Canada (TCC) or the Federal Court of Appeal (FCA). However, at the FCA level, there was a strong dissenting opinion that the obligation to carry out the reforestation obligations on the

acquired forest tenures was ‘embedded’ in the tenures themselves, simply depressed their value and no amount was includible in sale proceeds in respect of the agreement of the buyer to carry out the reforestation obligations. Therefore, the accounting reserve was not relevant, regardless of whether the parties had agreed on its amount. Counsel for the taxpayer was successful in obtaining leave to appeal to the SCC.

The SCC reversed the lower court decisions and, agreeing with the FCA dissenting opinion, ruled that DMI’s reforestation obligations were future costs that formed an integral part of the tenures and merely depressed their value. Consequently, the fact that the buyers agreed to assume these obligations did not result in additional sale proceeds. The SCC also commented that this approach eliminated the asymmetry inherent in the CRA approach.

Why is this decision important?

This decision is particularly important to resource industry companies because future reforestation, reclamation, and other environmental obligations are typically assumed on asset sales; indeed, legislation or the regulatory regime often requires that they be assumed. (An affidavit filed on behalf of a natural resource industry association said that its members had outstanding tax reassessments

totaling several billions of dollars resting on these issues.)

The SCC had an opportunity to address the broader issue of whether all types of assumed ‘contingent’ obligations should be treated as part of sale proceeds (for example, unfunded pension liabilities and post-retirement employee benefits) or should simply be regarded as future costs that are not appropriately treated as part of sale proceeds. The SCC found that in the case of the forest tenures, there was no liability of either an absolute or contingent nature assumed because of the ‘embedded’ nature of the reforestation obligations. The SCC said 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.

It was thus unnecessary for the SCC to address the distinction between contingent and absolute liabilities. It did however say that the assumption of a ‘future’ cost of repair of an asset would not form part of a vendor’s sale proceeds, even if that cost was absolute and not contingent.

Although these statements are potentially quite broad, the Court did

not provide definitive guidance on when an obligation will be ‘embedded’ in an asset, nor did it define a ‘future’ cost. These issues, and the related issue of the tax treatment of the assumption of other types of obligations, may be for another court to consider.

Finally, although the SCC did not address the position of the buyer of the forest tenures, its analysis appears inconsistent with CRA’s stated position that the assumed ‘liabilities’ were contingent liabilities, which were part of the purchase price paid for the assets and should be capitalized to the cost of the assets when the costs were actually incurred rather than deducted on a current basis.

Since the SCC clearly said that there were no liabilities that were assumed, it is difficult to see how the CRA’s policy that a buyer must add the amounts spent (presumably only up to the amount of the accounting reserve at the time of the purchase) to the cost of the acquired assets can survive this decision. Logically, the normal test for deductibility should apply: that is, are the amounts incurred by the buyer for the purpose of earning income, and thus deductible as a normal business expense?

Let's talk

For a more in-depth discussion of how this decision might affect your business, please contact:

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