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Supreme Court of Canada Clarifies that Assuming Obligations "Embedded" in a Property is not Consideration for the Property

By Francesco Gucciardo

The decision of the Supreme Court of Canada ("**SCC**") in *Daishowa-Marubeni International Ltd. v. Canada*, 2013 SCC 29, was released on May 23, 2013, reversing the decision of the Federal Court of Appeal. The issue on appeal to the SCC was whether or not the cost of certain reforestation obligations assumed by a purchaser in connection with the acquisition of certain forest tenures were to be included in computing the vendor's proceeds of disposition in respect of the sale of the tenures. The key question was whether the obligations were "embedded" in the property or separate or severable from the property.

Daishowa-Marubeni International Ltd. ("**DMI**") was the owner of forest tenures in Alberta under which it was licensed to cut timber. DMI's license was subject to a corresponding legal obligation to reforest the areas that it harvested. DMI sold two of its forest tenures and, in each case, the purchaser assumed the reforestation obligation that arose from DMI's past harvesting. The issue was whether DMI was required to include in its "proceeds of disposition" for each sale an amount in respect of the assumed reforestation obligations.

The Minister said DMI was required to include the amount in computing its proceeds of disposition as additional consideration for the tenures. The Tax Court of Canada agreed that the assumption of the reforestation obligations did form part of the consideration tendered for the tenures, but determined that it was not appropriate to add the entire estimated cost of the reforestation obligations to DMI's proceeds of disposition. Instead, the Tax Court included a discounted amount, being the estimated costs of the reforestation activities that would take place within the 12 months following the sale, plus 20 percent of the estimated costs of the activities that would take place thereafter.

On appeal, a majority of the Federal Court of Appeal held that the Tax Court of Canada erred in requiring DMI to include only a discounted amount and, instead, required DMI to include the entire estimated cost of the reforestation obligations in its proceeds of disposition. The dissenting judgment held that the reforestation obligations formed an integral part of the tenures that affected their intrinsic value and, as such, could not be viewed as separate consideration.

The SCC generally agreed with the dissenting judgment of the Federal Court of Appeal in holding that no amount in respect of the assumed reforestation obligations should be considered as additional consideration for the tenures. The SCC's decision turned on its assessment that the reforestation obligations assumed by the purchasers were properly characterized as a future cost "embedded" in the

tenures, which served to depress the tenures' value at the time of sale, rather than a separate liability of DMI that was assumed by each purchaser.

The SCC drew upon the examples of a property in need of repair and a property encumbered by a mortgage in explaining the difference between a future cost embedded in a property (that depresses the property's value) versus a liability of a vendor that is separate or severable from the property (and that does not impact the property's value). The SCC noted that a prospective purchaser of a property in need of repair would consider the cost of repair in formulating the purchase price in respect of such property, with the result that the obligation to undertake such repair and incur such future costs would depress the value of the property. If both the aggregate of the stated purchase price and the cost to undertake the future repairs were included as proceeds of disposition, one would be ignoring the fact that the underlying property does not have that value at the time of the sale. On the other hand, the value of a property encumbered by a mortgage is not generally affected by the fact that it is so encumbered: "For instance, a property worth \$31 million that is encumbered by a mortgage of \$11 million, despite the mortgage, still has a value of \$31 million. The vendor of such a property could obtain \$31 million for it and then pay off the mortgage. Alternatively, the vendor could obtain \$20 million and have the purchaser assume the mortgage. In either case, it makes sense for the vendor's proceeds of disposition to equal the full \$31 million because that is the value of the asset being sold."

The SCC found that the reforestation obligations were not a distinct existing liability but were embedded in the tenure by reason of the policy and practice of the province of Alberta. A prospective purchaser was forced to assume the reforestation obligations associated with the tenure as a tenure could only be transferred with the consent of the province of Alberta; officials from the province had confirmed that it would not approve of a transfer unless a purchaser agreed to assume the associated reforestation obligation. According to the SCC, the effect of the province of Alberta's scheme was to *embed* the reforestation obligations into the tenure, such that they could not be severed from the property itself. The reforestation obligations served to decrease the amount a prospective purchaser would be willing to pay for the property.

The SCC also held that a determination as to whether the assumed reforestation obligations were absolute or contingent obligations (an issue that garnered particular attention at the lower court levels) was irrelevant after having concluded that the obligations were not severable from the property; the certainty or likelihood of having to incur the cost of repair may affect the sale price, but does not impact whether such costs are included in the computation of proceeds. Finally, the Court was influenced by the fact that its approach would avoid asymmetry of the tax treatment accorded to each of the vendor and the purchaser.

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