The Supreme Court's 2013 Tax Cases: Side-Stepping the Interesting, Important and Difficult Issues

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Neil Brooks and Kim Brooks*

I. JUDICIAL ABSTENTION

In last year’s Supreme Court Law Review we wrote a somewhat lengthy introduction to the four tax cases the Court decided in 2012.1 We contrasted the formalistic approach that the Court took in resolving those cases with the more pragmatic and consequentialist approach we argued it should have taken. We will not repeat our concern here, although the three cases the Court decided in 2013 suffer as well from the Court’s formalist approach to tax law. Instead, we will briefly introduce these cases by lamenting another frequently noted characteristic of the Court’s tax cases, namely, its penchant for deciding tax cases on narrow grounds and its unwillingness to engage with the more interesting and important questions presented by the cases in which it grants leave to appeal.

The Supreme Court hears only a small number of tax cases a year: two, three or four. Given that its decision to consider a tax case represents a commitment of scarce and valuable resources that might have been devoted to cases that might be of more obvious importance to broader Canadian society, one might have supposed that the Court would choose tax cases in which the general expertise of the Court could illuminate difficult but contested and pervasive principles of tax law. One might have supposed that it would carefully select cases where it thinks it could make a contribution and that its judgments would be written to provide much needed guidance for the Canada Revenue Agency (“CRA”) and lower courts in how to achieve a more equitable, efficient

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and practicable income tax. Although the *Income Tax Act*\(^2\) is an incredibly detailed statute it is replete with gaps, conflicts, ambiguities and vague provisions. Tax law in large part is composed of administrative rules and practices and judge-made law.

Yet, to the extent that the Court does grant leave to appeal in cases that raise interesting, important and difficult tax issues, often the Court then sidesteps these issues, as demonstrated in the three cases decided in 2013. It resolves the cases by reference to a narrow formalistic point that settles the case but does nothing to advance our understanding of tax principles or tax law. Indeed, the Court often appears intent on avoiding at all costs the complexity of tax cases and tax policy making. This approach to tax cases seems inconsistent with the Court’s general institutional commitment to the quality of the legal system.

One of the important but unresolved issues in tax law is the tax treatment of contingent liabilities assumed by the buyer in a sale of business assets. The Act has no provision dealing with this issue and its resolution involves reconciling a number of competing tax principles. Numerous tax commentators have speculated on the correct tax treatment of assumed contingent liabilities and over the year the CRA has taken inconsistent positions.\(^3\) This was the issue raised in *Daishowa-Marubeni International Ltd. v. Canada*.\(^4\) Both lower courts struggled with the issue. However, the Supreme Court sidestepped the issue entirely by holding that the liability created in the case was not a contingent liability but a future cost embedded in an asset. As we argue below, they were wrong to re-characterize the transaction — it was clearly a contingent liability — but further, as we also argue, the application of tax principles to assumed contingent liabilities was the issue on which the Court could have made an important contribution. Not only did the Court not contribute to the resolution of the issue, but also in order to sidestep it the Court added a new layer of complexity to the issue by injecting a novel concept of “embedded” future costs into tax law.

The Act provides a detailed set of rules in section 87 that allow qualifying corporations to amalgamate without tax consequences. A tax issue that has puzzled the CRA and tax practitioners for years, and on which the Act is silent, is how amalgamations are taxed if they do not

\(^{3}\) *Infra*, note 12.  
meet the qualifying conditions of section 87. This issue arose in Envision Credit Union v. Canada,\(^5\) which involved a corporate amalgamation and an outrageous accompanying tax plan in which the taxpayer was attempting to claim a tax deduction for the same expense twice. Both lower courts dealt with the question of the taxation of amalgamations that did not qualify for non-recognition treatment under section 87 and both held that the taxpayer’s plan would fail under the appropriate tax treatment of such amalgamations. The Supreme Court held that section 87 applied to the transaction and as a result the tax plan was unsuccessful; consequently, it did not address the issue of the tax treatment of non-qualifying amalgamations. The Court was likely correct that section 87 applied to the taxpayer’s transaction but it based its holding on metaphysical grounds instead of an analysis of the purpose of section 87. Moreover, it is unfortunate it did not go on and say something about the absurdity of the taxpayer’s position with respect to the tax treatment of non-qualifying amalgamations.

There has been considerable uncertainty in lower level courts about the applicability of the restitutionary remedy of rectification in tax cases. Ambiguities have arisen around whether the remedy is available under the civil law, whether the approach to the remedy in the tax law context should mirror the approach taken in other substantive law areas (particularly contract law), and whether there are consistent boundaries to the application of the remedy that might be applied by lower level courts and administrative decision makers. In Québec (Agence du Revenu) v. Services Environnementaux AES inc.,\(^6\) the Supreme Court resolved the issues of the availability of rectification in the civil law context but sidestepped the resolution of the other issues that have troubled tax planners, policy makers, and lower levels of court.

II. DAISHOWA-MARUBENI INTERNATIONAL LTD. V. CANADA: WHEN IS A CONTINGENT LIABILITY NOT A CONTINGENT LIABILITY?

1. Interpreting the Statute versus Characterizing the Taxpayer’s Transaction

One of the reasons interpreting income tax law is so intellectually challenging is that for many tax issues the theoretically correct answer

may not be workable and consistent with the many policy compromises that have been made throughout the Act. Moreover, many administrative compromises have to be made in formulating tax rules and in interpreting them because the income tax is levied on an annual basis even though many business transactions remain ongoing for many years. Hence a first best answer to a tax interpretation problem may need to give way to a second best (or third or fourth best) answer that is reached only after balancing a number of competing considerations.

A question that has troubled the CRA and tax practitioners for many years, and for which there is no one right answer, is the appropriate tax treatment of contingent liabilities that have been assumed by a purchaser of business assets. Daishowa raised this issue. The case involved the sale of one of Daishowa’s timber businesses. In addition to the business assets, the purchaser assumed the reforestation liabilities that Daishowa had incurred in logging the forest tenures that formed part of the business.

Perhaps recognizing the difficulty of the issue raised in the case, Rothstein J., writing for a unanimous Supreme Court, light-heartedly posed the following question in the opening paragraph of his judgment, “In this appeal, the Court is called upon to answer an age-old question: If a tree falls in the forest and you are not around to replant it, how does it affect your taxes?”7 In the Tax Court of Canada, Miller J. was more direct in acknowledging the difficulty of resolving the issue. In a judgment following the Supreme Court’s decision, in which Daishowa was asking for an increase in the costs awarded, Miller J. stated, “The fundamental issue at the Tax Court of Canada was not complex in its formulation, but the resolution required a Cirque du Soleilian acrobatic twisting and turning to grapple it to the ground.”8 In spite of the need for twisting and turning, Miller J. reached a compromise judgment in resolving the interpretive issue facing the Court. Perhaps because they were unwilling to engage in the required twisting and turning, and dashing the hopes of those who had thought this case would resolve the question of the appropriate tax treatment of the assumption of contingent liabilities in an asset purchase, the judges of the Supreme Court finessed the issue by re-characterizing the taxpayer’s transaction at issue in the case as not involving a contingent liability. Ironically, in doing so the

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7 Daishowa, supra, note 4, at para. 1.
Supreme Court not only did not assist in resolving this important and difficult interpretive question, but added an additional layer of complexity to its resolution.

As a heuristic for promoting clear thinking about the resolution of tax cases, tax commentators, and even judges, sometimes note that applying tax law to transactions involves two steps: first, characterizing the taxpayer’s transaction for tax purposes and second, determining the governing tax law, which often involves an issue of statutory interpretation. In Daishowa, at the Tax Court level all of the parties assumed the case involved an issue of determining the governing tax law: how should contingent liabilities assumed on the purchase of business assets be treated for tax purposes, and in particular, should their value have to be included in the vendor’s proceeds of disposition? Justice Miller gave an extended judgment dealing with this issue and in holding for the Minister of National Revenue held that the taxpayer should have to include the value of the assumed reforestation obligations in the proceeds of disposition received for the forest tenures. This was also the basic issue dealt with by the majority in the Federal Court of Appeal, who also held in favour of the Minister. The dissent in the Court of Appeal, however, dealt with the case as if it raised an issue relating to the proper characterization of the taxpayer’s transaction; namely, whether the reforestation obligations assumed by the purchaser should be characterized as contingent liabilities for tax purposes or whether they should be treated as an integral characteristic of the assigned forest tenures themselves and thus simply have the effect of reducing the value of those tenures. On the basis that they should be treated as an integral part of the forest tenures, Mainville J.A. would have held for the taxpayers.

The Supreme Court granted leave to appeal on the question of whether “the reforestation liabilities [are] to be included in the proceeds of disposition because the vendor is relieved of a liability or are they integral to and run with the forest tenures?” Hence the Court indicated it was not interested in hearing arguments on the question that the Tax Court and the majority in the Federal Court of Appeal had dealt with, namely, the appropriate tax treatment of assumed contingent liabilities on an asset sale, but instead was treating the case as one involving only the characterization of the taxpayer’s transaction. This was an issue that was

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9 Daishowa, supra, note 4, at para. 22.
not argued or even mentioned in the Tax Court. In a subsequent judgment relating to the awarding of costs in the case, Miller J. referred to the Supreme Court of Canada as having “introduced a novel concept of ‘embedded’”\textsuperscript{10} into the analysis of the case and noted that at the Tax Court level he “did not have the benefit of any argument with respect to an ‘embedded’ liability”\textsuperscript{11}.

2. Facts

The facts of \textit{Daishowa} are straightforward; even so, to highlight the central issue the following is a somewhat simplified version. The taxpayer, Daishowa-Marubeni International Ltd., operated a timber division in the province of Alberta in which it harvested logs and manufactured finished timber. In 1999 it sold all of the assets of this division of its business. Among the assets was a forest tenure granted by the Alberta government. Under this forest tenure, Daishowa was licensed to cut and remove timber from designated provincial Crown land. The regulatory regime that governed forest tenures in Alberta required the licensee to reforest the areas it harvested (the “reforestation liability”). This reforestation liability would generally not be completely discharged until eight to 14 years after cutting the timber and its eventual total cost would be contingent on a number of factors such as the intervening weather and other environmental conditions. The regulatory regime also provided that the government of Alberta had to consent to the assignment of a forest tenure and that such consent would only be given if the purchaser of the tenure assumed the seller’s outstanding reforestation liabilities. Consequently, when Daishowa assigned its forest tenure to the purchaser of this division of its business, the obligation to finish reforesting the areas Daishowa had logged was also assumed by the purchaser.

The purchaser’s initial offer for all of the assets of the business was $180 million cash minus the estimated reforestation liabilities. However, on the advice of Daishowa’s tax advisers, the purchase price in the final agreement was stated to be $169 million and a term in the agreement simply provided that the purchaser would assume the relevant reforestation obligations. The parties agreed that the reforestation liabilities had a value of about $11 million.

\textsuperscript{10} Daishowa-Marubeni, supra, note 8, at para. 15.
\textsuperscript{11} Id., at para. 24.
Daishowa reported the proceeds of disposition of the business assets as being the cash it received, $169 million. It allocated this amount among the assets. In the purchase agreement, $20 million was allocated to the forest tenure. (Presumably it would have been $31 million if there were no outstanding reforestation liabilities.) Consistent with its administrative position relating to the tax treatment of assumed liabilities in an asset purchase, the Minister of National Revenue reassessed Daishowa and added the value of the contingent reforestation liabilities assumed by the purchaser, namely, $11 million, to Daishowa’s proceeds of disposition. Hence the Minister treated the forest tenures as having been sold for $31 million — $20 million cash plus $11 million representing the value to Daishowa of the purchaser assuming the outstanding reforestation liabilities.

The CRA’s assessing practice with respect to the assumption of contingent liabilities in a purchase and sale transaction has been set out in numerous technical interpretations that are invariably discussed and analyzed in articles on the tax consequences of the purchase and sale of a business.12 Basically, the CRA requires the fair market value of contingent liabilities to be included in the vendor’s proceeds of disposition at the date of the sale. However, it does not allow the purchaser to add the value of the contingent liabilities to the cost basis of the assets until the liabilities have been paid. Moreover, it does not allow the seller to deduct the amount that it paid (usually in the form of a reduced cash purchase price for the sold assets) to have the purchaser assume the liabilities. This assessing practice can lead to the seller being taxed on income it has never received.

The tax bar has always been concerned about the CRA’s assessing practice, but it has been of particular concern to resource industry companies because future reforestation, reclamation and other environmental obligations are typically assumed on asset sales in that

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industry. Apparently, following its win in the Tax Court the CRA became emboldened in reassessing taxpayers in the oil and gas industry that had sold properties with reclamation obligations attached to them. The Canadian Association of Petroleum Products Producers, one of the many interveners at the Supreme Court of Canada, reported that there were outstanding reassessments in the industry totalling several billion dollars.\(^13\)

To provide some context for the specific issue raised in the case, the following is a brief description of the tax treatment of forest tenures generally. Licences to remove timber (forest tenures) are taxed as “timber resource property” under the Act.\(^14\) Timber resources properties are treated as depreciable capital property and their capital cost can be depreciated on a straight-line basis at a rate of 15 per cent a year.\(^15\) However, unlike most other depreciable properties, if they are sold for more than their capital cost the excess amount is not taxed as a capital gain but instead is taxed as ordinary income.\(^16\) Upon the sale of a timber resource property the owner must include in income the total amount by which the “proceeds of disposition” of the property exceed its undepreciated capital cost.\(^17\) Like the more general provision dealing with the sale of capital property,\(^18\) for this purpose “proceeds of disposition” is defined as “the sale price of property that has been sold”.\(^19\) Hence the issue in the case might be restated as whether the assumption of a contingent liability by a purchaser should be treated as part of the sale price of property that has been sold. Of course there might be other tax consequences for the seller when a purchaser assumes a contingent liability in an asset purchase and the tax consequences to the purchaser are also important and contentious. With this case the tax community was hoping all of this would be sorted out, but as we describe below, the Supreme Court sidestepped the issue entirely.

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\(^{13}\) Daishowa-Marubeni, supra, note 8, at para. 12.
\(^{14}\) Income Tax Act, supra, note 2, s. 13(21) “timber resource property”.
\(^{15}\) Income Tax Regulations, C.R.C., c. 945, Sch. II, Class 33.
\(^{16}\) Income Tax Act, supra, note 2, s. 39(1)(a)(iv) excludes a timber resource property from capital gain treatment.
\(^{17}\) Id., ss. 13(1), 13(21) “undepreciated capital cost” (variable G).
\(^{18}\) Id., s. 54 “proceeds of disposition”.
\(^{19}\) Id., s. 13(21) “proceeds of disposition”.

(a) Tax Court of Canada

As mentioned above, in reassessing Daishowa upon the sale of its forest tenures, the CRA included in its proceeds of disposition not only the cash it received ($20 million) but also the value to Daishowa of the purchaser assuming its outstanding reforestation liabilities ($11 million).

In contesting the reassessment in the Tax Court, Daishowa made three arguments:

(1) The reforestation liabilities should not be included in the proceeds of disposition since they were contingent and the fair market value of the liabilities was not determinable at the time of closing.

(2) Alternatively, if the value of the reforestation liabilities were to be included in the proceeds, that value should be much less than the accounting estimate of $11 million.

(3) And, also alternatively, if the value of the contingent liabilities were included in the proceeds of disposition, Daishowa should be entitled to an offsetting deduction from income.

On the first issue, in upholding the Minister’s reassessment, Miller J. had little difficulty concluding that the assumption of the reforestation liability was part of the consideration for the sale of the forest tenure. In reaching this conclusion he made the following points:

- The definition of proceeds of disposition in the Act was clearly broad enough to include any consideration, including an assumption of a liability.
- Daishowa admitted that if they had to pay this liability, that is, if the purchaser had not assumed it, they would have insisted on increased cash or other consideration for the sale of the forest tenures.
- The assumption of Daishowa’s contingent liability by the purchaser can be regarded as separate consideration for the sale. The reforestation obligations do not “flow” with the forest tenure even

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21 Id., at para. 25.
22 Id., at para. 24.
though the provincial regulatory regime requires a purchaser to assume them.  

- The fact that in the final agreement the parties specifically excluded the assumption of liability from the purchase price is irrelevant. The consideration for the sale is what it is regardless of what the parties state in their contract. To hold otherwise would be to “put form over substance”.  

- No principle of tax law holds that, because the eventual value of consideration given as proceeds of disposition is uncertain, it therefore should not be valued at the time of sale and treated as proceeds of disposition. Although the uncertainty should be taken into account in determining the fair market value of the consideration, the fact that the value of a contingent liability cannot be determined with certainty does not mean that it should be treated as being zero.  

On the second issue Miller J. agreed with Daishowa that the $11 million accounting estimate of the reforestation liabilities, which was agreed upon by the parties, should not necessarily be treated as the value of the contingent liability for tax purposes. He reviewed a wide range of factors that he suggested justified deeply discounting the $11 million figure, at least that part of it attributable to the long-term reforestation liability. Frankly, this part of his judgment is somewhat difficult to understand, and since it was dismissed by the Federal Court of Appeal, is not dealt with by the Supreme Court, and is not relevant to our concluding analysis of this case, we will say no more about it.

The third point argued by Daishowa at the Tax Court of Canada was that if it was required to include an amount for the reforestation liabilities in its proceeds of disposition for the sold property it should be entitled to a corresponding deduction from income. The logic of this position, Daishowa argued, was that by paying the purchaser with assets to assume the liabilities it had effectively paid off the liabilities and since the liabilities represented a current expense they should be entitled to a current deduction for that amount.

23 Id., at para. 26.
24 Id., at para. 27.
25 Id., at paras. 28-39.
26 Id., at paras. 40-42.
Justice Miller was clearly confused by this argument. He referred to it as “somewhat circuitous” in that Daishowa appeared to be arguing that “it was not only the vendor of assets and a recipient of consideration”. He notes that Daishowa did not pay the purchaser “separately to incur the reforestation expenditures” but that “[t]his deal was for the sale of capital assets: the assumption of the reforestation liability was simply part of the capital transaction”. He exclaimed that “to view the transaction as payment for the reforestation costs by the transfer of the forest tenures … is an Alice in Wonderland topsy turvy approach”. Moreover, even if the transfer of the forest tenures could be regarded in part as payment for the purchaser assuming the liabilities, Miller J. reasoned that “the payment smacks more of an enduring benefit than current expense of the actual reforestation”.

Justice Miller seemed to recognize that by taxing Daishowa on the value of having the purchaser assume the reforestation liabilities but not allowing them a deduction for the expenses they represented Daishowa would be paying tax on income it had not earned. (We agree and explain why this is the case below, and argue that for this reason Daishowa should have been allowed to deduct this amount.) He stated frankly that he agreed with Daishowa “that there is a certain lack of symmetry in how the assumption of the reforestation liability is treated for tax purposes. … the value of the assumption of that very liability to incur those costs falls into income as proceeds in one fell swoop, with no recognition that the income recipient has no future opportunity to deduct such expenses”. Somewhat oddly, although not dealing directly with this incongruity, he stated that he used this economic reality “to justify my view that the face amount of the assumption of the liability should be discounted”.

(b) Federal Court of Appeal

A three-judge panel at the Federal Court of Appeal was divided in its analysis of the case. The majority, in a judgment written by Nadon J.A.
and concurred with by Layden-Stevenson J.A., agreed with the trial judge that the value of the assumed reforestation liability should be included in Daishowa’s proceeds of disposition for its business assets. However, contrary to the holding of the trial court judge, the Court of Appeal held that value of the assumed liabilities was the amount agreed upon by the parties (even though this might not be their fair market value), namely, $11 million, and not the much lesser discounted amount arrived at by the trial judge. The Court of Appeal also agreed with the trial judge that Daishowa was not entitled to a deduction for having effectively paid off its reforestation liabilities with assets.

In reaching the conclusion that the assumption of the reforestation liabilities constituted part of the consideration for the forest tenures, Nadon J.A. simply summarized and quoted from the trial judge’s reasons for so holding and stated that he could “find no error in the Judge’s reasoning.”

However, contrary to the trial judge’s finding that the value of the reforestation liability was less than the amount agreed to by the parties, he went on to hold that on his reading of the contract between the parties they had agreed that $11 million was the amount to be paid for the assumption of the reforestation liabilities and, therefore, he held, it was not open for the trial judge to discount this amount. He stated that if “the parties agree to accept a certain amount as consideration” for property in an asset sale, then that amount must be accepted by the CRA. Underlining this point, he went on to say, that “[i]f the parties attribute no value to a future liability, then there is nothing to be added to the seller’s proceeds of disposition for the purposes of taxation.” That is to say, he held that in valuing the contingent liability the only question is what value the parties assigned to it in their agreement of purchase and sale.

Justice Nadon then turned to the third issue raised by Daishowa at the Tax Court of Canada, which he stated as follows: “Was the appellant entitled to claim either a deduction from its income or include the capital expenditure amount paid for having the purchasers [Tolko] assume the reforestation liability in its adjusted cost base?” Just to be clear about the taxpayer’s argument: The taxpayer argued, in the alternative, that if it

34 Id., at para. 49.
35 Id., at para. 66.
36 Id., at para. 79.
37 Id., at para. 34.
was required to include the reforestation obligation amounts in its proceeds of disposition, then it should be able to deduct an offsetting amount. Daishowa argued that if it had discharged the reforestation liabilities by reforesting it would have been entitled to deduct all expenses incurred as current expenses. Instead of paying off the liability directly, it discharged it indirectly by paying the purchaser to assume the liabilities. It paid the purchaser for this assumption of liabilities by accepting a lower purchase price for the forest tenures than it would otherwise be entitled to receive; in effect, that part of the value of the transferred forest tenures that the Minister alleged was paid for by the purchaser assuming the reforestation liabilities must necessarily represent consideration for the assumption of the reforestation liabilities.\(^{38}\) (As we observed above, we agree with the taxpayer’s argument on this point. We explain why below.)

Justice Nadon rejected the taxpayer’s alternative argument by again adopting the reasoning of the Tax Court: “the judge decided against the appellant on this point because of his view that the transaction was one for the sale of capital assets and that the assumption of the reforestation liability was ‘simply part of that capital transaction’…. I see no basis to disagree with the Judge’s reasoning.”\(^{39}\) He said, “[i]n the present matter, it is my view that it is an enduring benefit to the appellant to be relieved of a long term reforestation liability associated with the forest tenure.”\(^{40}\) Further, he explained, “[t]he forest tenure, being a piece of land with a forest on it, has a capital nature. The reforestation liability, by law, passes with the ownership of the tenure itself. Hence, the reforestation liability also has a capital nature.”\(^{41}\)

Both the Tax Court judge and the majority of the Federal Court of Appeal dealt with this case as if it raised an issue of statutory interpretation, namely, how should contingent liabilities assumed on the sale of business assets be treated for tax purposes? The dissenting judge in the Federal Court of Appeal, Mainville J.A., however, completely finessed this issue by treating the case as one involving the characterization of the taxpayer’s transaction. He did not necessarily disagree with the majority’s view of how assumed contingent liabilities should be taxed. Instead, he held that the case did not involve the

\(^{38}\) Id., at para. 86.

\(^{39}\) Id., at para. 87.

\(^{40}\) Id., at para. 89.

\(^{41}\) Id.
assumption of a contingent liability at all, but involved the sale of a capital asset, namely, a forest tenure, to which a liability to reforest was “inextricably linked” or as he sometimes put it was an “integral part of” or was “embedded in”. That is to say, he held that assumption of the reforestation liability could not form a separate component of the consideration for the sale of the forest tenure because that liability was not distinct from the forest tenure itself. The effect of the liability was simply to depress the value of the forest tenure much in the same way that the value of an asset is depressed if it is in need of repair. He noted that no one would suggest that a seller of an asset in need of repair should be treated as having disposed of the asset for its value plus the cost of the needed repairs. In the same way, in this case, the fact that there was a future liability that the purchaser assumed in purchasing the asset should not be treated as separate from the asset itself and the value to the seller of having it discharged added to the proceeds of disposition. The effect of the reforestation liabilities was simply to depress the selling price of the asset but aside from that it had no tax consequences.

Why did he conclude that this liability should be treated as embedded in the asset instead of being a distinct liability? The main reason appears to be that in order for the seller to obtain provincial government approval of the transfer of a forest tenure the purchaser had to agree to assume all outstanding reforestation liabilities.

He supported his conclusion by noting that sections of a statute should be interpreted in a way that is “harmonious with the act as a whole” and that “promotes symmetry and fairness”. He observed that the approach taken by the majority and the Tax Court resulted in a lack of symmetry since, and here he quoted directly from Miller J.’s judgment, “the value of the [assumption of the reforestation liability] … falls into income as proceeds … with no recognition that the income recipient has no future opportunity to deduct such expenses.”

Although it was not necessary for him to decide the issue of how the contingent liabilities would be valued if their discharge were included in the seller’s proceeds of disposition, he supported his conclusion that the contingent liabilities should be ignored by noting the incongruity of the majority’s position that the liabilities should be given the value that

42 Id., at para. 140.
43 Id., at para. 128.
44 Id., at paras. 136-137.
45 Id., at para. 129.
46 Id., at para. 133.
the parties assigned to them in their agreement. He observed that this position meant that if the parties do not “identify the value of the reforestation liabilities, those liabilities may well not be included in the proceeds of disposition and thus escape taxation in the hands of the vendor, while in circumstances where the parties are transparent in their transactions and clearly identify the value of the reforestation liabilities, these would be accordingly included in the vendors taxable proceeds”.

(c) Supreme Court

This case was argued both at the Tax Court and the Federal Court of Appeal as a case involving the proper tax treatment of a contingent liability assumed as part of an asset sale, including whether, if the value of the liabilities should be treated as part of the proceeds of disposition of the assets, an amount representing the amount the seller paid the purchaser for assuming the liabilities could be deducted from the seller’s income. However, the Supreme Court did not grant leave on this question. Instead leave was granted only on the question of whether or not the reforestation liabilities were in fact contingent liabilities. Leave was granted on the following issues:

1. Are the reforestation liabilities to be included in the proceeds of disposition because the vendor is relieved of a liability or are they integral to and run with the forest tenures?

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

What is odd about these questions is that commentators, the taxpayer in this case, the CRA, and the lower courts in this case conceded that the question of how a contingent liability assumed on an asset sale was to be treated for tax purposes was contentious and important. Yet in granting leave the Supreme Court did not ask the parties to address this issue. The Court simply asked them to address whether or not the reforestation liabilities were in fact contingent liabilities. One wonders if they had made up their minds that it was not a contingent liability or if they believed that the tax treatment of contingent liabilities was straightforward and therefore concluded in advance that if they held that

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47 Id., at para. 142.
48 Daishowa, supra, note 4, at para. 22.
the reforestation liabilities were contingent liabilities they would not require arguments about how they should be taxed.

In any event, in holding for the taxpayer a nine-member Supreme Court bench unanimously reversed the Federal Court of Appeal. Justice Rothstein, writing for the Court, followed both the conclusion and the reasoning of dissenting Mainville J.A. in the Federal Court of Appeal. He added no new reasoning or insights. Justice Rothstein held that the reforestation liabilities could not be severed from the forest tenures themselves but were embedded in them because of the policy of the Alberta government that required a purchaser of forest tenures to assume all outstanding reforestation liabilities. Like Mainville J.A., he supported his holding by an analogy to an asset in need of repair and to the asymmetrical tax treatment that resulted from the holding of the majority in the Federal Court of Appeal.

Justice Rothstein acknowledged “[a]s a matter of principle, the assumption of a vendor’s liability by a purchaser may constitute part of the sale price and therefore part of the vendor’s proceeds of disposition.” 49 He illustrated this point with a simple example of a property that is encumbered by a mortgage. If a purchaser pays for the property by paying some cash and by assuming the outstanding mortgage, then the amount of the cash and the amount of the mortgage liability assumed would both be included in the vendor’s proceeds of disposition.50 This is an odd point for Rothstein J. to make in this case since the case did not involve a fixed liability, like a mortgage, but a contingent liability. The tax treatment of the assumption of fixed liabilities is indeed relatively straightforward, in part, since the seller will have claimed a deduction or increased the cost of its assets in an amount equal to the amount of the fixed liability. The tricky question is the tax treatment of the assumption of contingent liabilities where even though the liability will have accrued economically and diminished the value of the business of which the assets are part, the seller has not yet claimed a deduction or had any addition to the cost of its assets (in most cases because the liability is too contingent to be recognized for tax purposes). That was the circumstance in *Daishowa*.

However, as mentioned, the Supreme Court sidestepped the issue of the tax treatment of contingent liabilities altogether by finding that the reforestation obligations were not liabilities, but rather they were future

49 *Id.*, at para. 26.
50 *Id.*
costs embedded in the land tenures. As stated by Rothstein J., “[T]he 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.” Following the reasoning of Mainville J.A., Rothstein J. concluded that the reforestation obligations were not contingent liabilities but embedded in the forest tenures themselves since “Alberta’s regulatory scheme … prevents a vendor from selling a forest tenure without also assigning the reforestation obligations that have arisen from past harvesting.”

The fact that Daishowa and the purchaser had agreed to an estimated future cost for the reforestation obligation and reduced the price accordingly and the fact that Daishowa had estimated the cost of the future reforestation obligations when computing income for accounting purposes were found to be irrelevant. Furthermore, the question of whether the reforestation obligation was a contingent or fixed liability was not considered relevant.

Also following Mainville J.A., and in support of his conclusion, Rothstein J. analogized forest tenures with reforestation obligations to properties in need of repair. No one would argue that a seller should have to add the cost of needed repairs to the proceeds of assets sold on the grounds that the purchaser had assumed those costs from the seller when the asset was sold, even if, as Justice Rothstein notes, the repairs were required by law. In oral argument the Minister argued that the repair analogy was inapt since unlike a repair in this case the taxpayer had incurred the liability to reforest before the sale. But Rothstein J., acknowledging an oral argument made by Mr. Meghji for the Canadian Association of Petroleum Producers, stated that the Minister’s attempt to distinguish the reforestation liabilities from a repair assumed that reforestation liabilities were a distinct existing debt and in fact they were not but instead they “were embedded in the tenure so as to be a future cost associated with ownership of the tenure.”

As noted above, the Minister’s assessing position with respect to the assumption of contingent liabilities in asset sales was that although the

51 Id., at para. 35.
52 Id., at para. 36.
53 Id., at paras. 45-46.
54 Id., at para. 40.
55 Id., at para. 28.
56 Id., at para. 34.
57 Id., at para. 35.
value of the contingent liability (in this case the $11 million estimated costs of the reforestation obligations) assumed by the purchaser should be included in the vendor’s proceeds of disposition, it should not be included in the purchaser’s adjusted cost base (at least until the purchaser actually incurred the expenses). Justice Rothstein supported his holding that the obligations should be treated as being embedded in the forest tenures because it avoided this asymmetrical tax treatment. He noted that under the Minister’s approach, if the purchaser’s cost base was $20 million, the cash amount paid, but upon sale the proceeds had to include not only this cash amount but also the assumption of the future reforestation costs then if the purchaser sold the forest tenure the day following the purchase from Daishowa the proceeds would be $31 million (assuming the reforestation obligations were still $11 million). The purchaser would be taxed on $11 million of income it clearly had not received. Justice Rothstein noted that the avoidance of asymmetry was not dispositive, but that, again paraphrasing Mainville J.A., “an interpretation of the Act that promotes symmetry and fairness through a harmonious taxation scheme is to be preferred over an interpretation which promotes neither value.”

3. Analysis

(a) The Supreme Court’s Unfortunate Mischaracterization of the Taxpayer’s Transaction

It is unfortunate that instead of dealing with the question of the tax treatment of contingent liabilities the Supreme Court re-characterized the taxpayer’s transaction as one not involving a contingent liability. As we argue below they were wrong to re-characterize the transaction — it was clearly a contingent liability — but further the tax treatment of assumed contingent liabilities was the issue that needed to be resolved in this case. A good deal of uncertainty surrounds this issue; it is often an important one in the purchase and sale of business assets; and, in many cases the CRA’s present administrative practice taxes taxpayers on income they have not received. The Court missed an opportunity to clarify the application of tax principles to these transactions. Although the Court might have characterized the transaction as involving liabilities

58 Id., at para. 42.
59 Id., at para. 43.
embedded in an asset in order to reach what they regarded as a sensible result, if they had grappled with the appropriate tax treatment of contingent liabilities presumably a sensible result would have been reached as well. As a result of their failure, either another taxpayer will have to take a case to the Supreme Court to clarify the tax treatment of contingent liabilities or its treatment will have to be clarified by legislative amendment. Also, as a result of the decision, not only has the tax treatment of contingent liabilities not been resolved but also a new layer of complexity has been added to the determination of the appropriate tax treatment of the assumption of liabilities in an asset sale: now as a preliminary matter taxpayers have to determine if they are dealing with contingent liabilities or liabilities that are embedded in the transferred asset. Prior to this case no one assumed this distinction made any difference for tax purposes. In a hearing on whether the award of costs in this case should be increased, Miller J. noted that the Supreme Court “introduced a novel concept of ‘embedded’” in resolving the case.60

Also unfortunately, the Court provided almost no guidance as to when a liability associated with an asset will be considered embedded in that property for tax purposes. In this case Rothstein J. stated that the liabilities were embedded since the purchaser of the assets was required to assume them under Alberta’s regulatory scheme for forest tenures, but he went on to say that “I would certainly not foreclose the possibility that obligations associated with a property right could be embedded in the 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.”61 But beyond this the Court provided no examples or gave any guidance to assist taxpayers in determining whether a liability is embedded.

But most importantly, and unfortunately, the decision is wrong. In ordinary usage Daishowa’s reforestation obligations were a contingent liability. In their own financial statements Daishowa treated them as contingent liabilities. And in law, given the usual legal meaning assigned to the terms “liabilities” and “contingencies” the reforestation obligations were contingent liabilities. There is no question they represented a liability. Daishowa had cut the timber in the forest tenures and had a future obligation to reforest. Although what amounts to a contingent

60 Daishowa-Marubeni, supra, note 8, at para. 15.
61 Daishowa, supra, note 4, at para. 36.
liability has been the subject of countless cases, normally a payment will be regarded as contingent if there is some uncertainty about whether it will have to be made, what amount will have to be paid, and when the payment will have to be made. In this case there was significant uncertainty about how much would have to be paid in discharging the reforestation obligations and when it would have to be paid. Indeed, although Daishowa deducted these liabilities in its own financial statements, the reason it could not deduct them for tax purposes was because they were a contingent liability for tax purposes.\textsuperscript{62} If the reforestation obligations were contingent liabilities so long as they had to be discharged by Daishowa, why should their characterization change when they were assigned to a purchaser?

Justice Rothstein notes that the effect of the liabilities was to reduce the value of the forest tenures. He suggests that because a purchaser would necessarily pay less for the forest tenures because of the reforestation obligations these obligations are embedded in the property.\textsuperscript{63} However, the effect on the value of the asset does not distinguish these obligations from a contingent liability. Anytime a purchaser buys an asset and assumes a liability they will necessarily pay less (cash) for the asset. This is because the assumption of the liability is payment, in part, for the asset. This is exactly what happened in \textit{Daishowa}. The purchaser paid less (cash) for the assets because they assumed the reforestation liability. Justice Rothstein’s attempt to support his embedded claim by noting that “the reforestation obligations are simply a future cost tied to the tenure that depresses the value of the tenure”\textsuperscript{64} begs the question. It assumes the obligation is not a contingent liability. Contingent liabilities have the same effect.

The only justification the Court gave for treating the reforestation liabilities as future costs embedded in the forest tenures as opposed to contingent liabilities was that upon a sale of the forest tenures the purchaser was required to assume the reforestation liabilities.\textsuperscript{65} But why should that matter? As a matter of ordinary usage in referring to the obligations, or more importantly as a matter of tax principles, why

\textsuperscript{62} And thus their deductibility was expressly prohibited under the \textit{Income Tax Act}, supra, note 2, s. 18(1)(e).
\textsuperscript{63} \textit{Daishowa}, supra, note 4, at para. 31, citing J. Frankovic, “Supreme Court to Hear \textit{Daishowa} Appeal — Back to Basics on Basis and Proceeds” (July 12, 2012), CCH Tax Topics No. 1205, at 2-3.
\textsuperscript{64} \textit{Daishowa}, id.
\textsuperscript{65} Id.
should it matter if the purchaser of assets voluntarily acquires obligations as a result of negotiations or is required by law to assume the obligations? Why should the fact that they were required to be assumed change their characterization from contingent liabilities to future costs embedded in the assets? Certainly the Court did not give any justification in terms of tax principles or any other reasons why this distinction should matter.

In supporting its conclusion, the analogy the Court makes to repairs is not persuasive. Justice Rothstein stated that “[t]he obligations — much like needed repairs — are a future cost embedded in the forest tenure that serves to depress the tenure’s value at the time of sale.” But of course this is just a description not a reason for treating the liabilities like repairs. In his oral argument the Minister distinguished the obligations from repairs on the grounds that in the case of the reforestation obligations the liabilities had been incurred whereas in the case of an asset in need of repairs no liabilities are incurred until the repair work is undertaken. Picking up on an argument made by Mr. Meghji for the Canadian Association of Petroleum Producers, Rothstein J. noted that the Minister’s attempt to distinguish the reforestation obligations from repairs “presupposes that the reforestation obligations are a distinct existing liability”. But again this assertion simply asserts a conclusion. If the Court had found that the reforestation obligations were not a distinct existing liability on other grounds (and assuming that as a matter of tax principles that characteristic of the liabilities should be given significance) the analogy to repairs, although it might illustrate the effect of the obligations (to diminish the value of the asset), does not provide a further distinct reason for equating the two cases. Moreover, an obvious difference between the reforestation obligations and an asset in need of repair that is repaired by a purchaser is that the reforestation obligations in this case were a liability that was incurred by the seller whereas the repairs would be an expense incurred by the purchaser.

What appeared to trouble the Court about the case, and one suspects accounts for their granting leave to appeal and treating it as a case involving the characterization of the taxpayer’s transaction, was that the CRA’s administrative practice with respect to the assumption of contingent liabilities clearly results in an inappropriate tax result. On the assumption of a contingent liability in the sale of business assets the

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66 Id., at para. 29.
67 Id., at para. 35.
CRA requires the seller to include the value of the liability in the proceeds of disposition of the assets but does not permit the purchaser to add that amount to the adjusted cost base of the assets until the expenses are actually incurred. Further, it does not provide the seller with a deduction for having discharged the liabilities. As the Court notes, this means if the purchaser sold the assets one day after purchasing them the purchaser would be taxed on the value of the contingent liabilities (assuming they had not been settled) even though this amount does not reflect additional income or a change in the value of the assets during its ownership.68 After noting this result, Rothstein J. justifies his holding, in part, by noting, “[t]he conclusion I have reached — that a purchaser’s assumption of reforestation obligations does not form part of the vendor’s proceeds of disposition — avoids this asymmetry. Although not dispositive, as Mainville J.A. recognized in his dissent, an interpretation of the Act that promotes symmetry and fairness through a harmonious taxation scheme is to be preferred over an interpretation which promotes neither value.”69

This justification for holding that the taxpayer’s reforestation obligations were embedded in the forest tenures is odd for a number of reasons.

First, Rothstein J. is using an approach to statutory interpretation — statutes should be interpreted to promote symmetry and fairness — to justify a particular characterization of the taxpayer’s transaction. The problem with this strategy is that it solves the fact that the statute might be unfair only for those cases in which the taxpayer’s transaction can be re-characterized. In this case, for example, it solves the asymmetry problem only for those contingent liabilities that can be characterized as embedded in a related asset. Presumably the asymmetry still exists for contingent liabilities that cannot be so re-characterized.

Second, the argument assumes there is a general tax principle that the tax treatment of sellers and purchasers should be symmetrical. But there is no such principle. Tax principles apply to individual taxpayers. An equitable tax system attempts to measure the change in the net wealth (and the value of goods and services consumed in the case of individual taxpayers) of each taxpayer. It is difficult to see why one taxpayer’s change of net wealth should ever depend upon the change of net wealth of another. Further, the tax characteristic of an asset or payment often

68 Id., at para. 42.
69 Id., at para. 43.
changes as it passes from one taxpayer to another. A particular asset might be inventory of the seller but capital property of the purchaser; a payment might be a non-deductible personal expense of the payer but taxable business income of the payee. The application of this principle is likely to lead to the wrong result in future cases, as it did in this case. As we explain below, this aspect of the CRA’s assessing position on this issue is correct. The value of a contingent liability should be added to the seller’s proceeds of disposition but only added to the purchaser’s adjusted cost base when the expense is incurred.

A third oddity of this justification for the Court’s holding is that Rothstein J. refers to Mainville J.A.’s dissent in the Federal Court of Appeal in noting that an interpretation of the Act that promotes symmetry should be preferred over one that does not.70 But the asymmetry that troubled the trial judge, and was of concern to Mainville J.A., was not the asymmetrical treatment of the seller and purchaser that resulted from the CRA’s assessing practice but instead was the asymmetrical treatment in the hands of the seller of the amount paid by the seller to the purchaser for assuming the contingent liability. Consistent with the CRA’s assessing practice, the trial judge held that the seller had to include the value of the assumption of reforestation liabilities in its proceeds of disposition but that it could not deduct that value from its income in the year of sale as being an amount paid for the discharge of the liabilities. That is to say, even though the purchaser had assumed the liabilities and their value was being treated as consideration for the sale of assets, the fact that the seller had discharged the liabilities by paying the purchaser to assume them was not being recognized with an income deduction. Even though his holding in the case did not provide a remedy, the trial judge did state, “I agree with the Appellant that there is a certain lack of symmetry in how the assumption of the reforestation liability is treated for tax purposes. No deduction is allowed until costs of reforestation are actually incurred, yet the value of the assumption of that very liability to incur those costs falls into income as proceeds in one fell swoop, with no recognition that the income recipient has no future opportunity to deduct such expenses.”71 This was also the asymmetry that concerned Mainville J.A. about the majority view in the

70  Id.
71  Supra, note 20, at para. 47. But he did go on to explain, “This logic leads somewhat full circle to justify my view that the face amount of the assumption of the liability should be discounted to reflect this economic reality.”
Federal Court of Appeal. This concern makes sense since the Act should treat amounts as they relate to a particular taxpayer symmetrically in order to correctly measure that person’s income. In this case, this asymmetrical problem is easily solved by allowing the seller a deduction from income for the amount they have paid to discharge the liabilities, as we explain below.

(b) How the Assumption of Contingent Liabilities on the Sale of a Business Should Be Taxed

This is not a paper on the taxation of contingent liabilities assumed by a purchaser in an asset sale, but in order to place some of the issues raised in Daishowa in a larger tax context, and to suggest how the Court might have approached the issues it faced, we briefly discuss how the assumption of contingent liabilities on the sale of a business should be taxed.

Like all tax rules, the rules governing the assumption of contingent liabilities should be consistent with both general tax principles and those specific principles that underlie the major structural features of the Act. The rules should also be easy to administer. To reduce tax-induced behaviour and to minimize arbitrary line drawing they should also be consistent with closely analogous transactions, namely, a cash-only sale and a sale involving the assumption of a fixed liability.

At least in a straightforward case, there is no controversy about the tax treatment of cash-only sales of business assets. Assume a seller has an asset with a cost basis of $50 and a fair market value of $100. The seller also has an outstanding bank loan of $10 that is secured with a charge on the property. If the bank loan had been used to pay current business expenses it will have been deducted from the seller’s income; if it was used to purchase an asset it will have been added to the cost basis of the asset. If a purchaser buys the asset for $100 cash the seller will have a $50 gain that will be subject to tax. If the seller uses $10 of the proceeds to pay off its outstanding liabilities there will be no tax consequences since the seller will have already deducted that $10 or added it to the cost basis of an asset. The purchaser will have a cost basis of $100 in the asset acquired.

72 Supra, note 33, at para. 133.
Instead of paying all cash, if the purchaser assumes the liability, the same result should be reached. The seller will only receive $90 cash but by assuming the $10 liability the purchaser has effectively paid $100 for the assets and that should be reflected in the gain that the seller reports and in the purchaser’s cost of the assets acquired. The obvious point is that the value of liabilities assumed by the purchaser should be included in the price paid for the assets. In this case the seller has received $90 cash plus $10 of liability relief. The seller will have also either deducted the amount of the liability if it was used for current expenses or added it to the cost basis of assets. When the purchaser repays the loan there will be no tax consequences since the amount of that liability has been reflected in the cost of the assets.

The tax equivalence between the cash-only sale and the cash and assumption of fixed liability sale should presumably also apply to the assumption of a liability that is contingent, to the extent possible. However, that is where the analysis gets more difficult for two reasons. First, if the seller has a contingent liability the value of the business will be less than the fair market value of the assets, but unlike the case of a fixed liability the seller will not have claimed a deduction for this diminishment in the value of the business nor will it have been added to the cost of the assets. Generally, contingent liabilities are not recognized for tax purposes until they become determinable. Second, although the parties will presumably assign a value to the contingent liability in determining how much cash the seller is entitled to, the final cost of the business to the purchaser will be uncertain until the liability becomes determinable. Although there are a number of ways these problems could be dealt with, one obvious way is to include the estimated value of the contingent liability in the seller’s proceeds of disposition but to avoid taxing the seller on income it has not received by allowing the seller to deduct the amount it notionally pays the purchaser to assume the liabilities. With regard to the second problem, the purchaser could be required to wait until the contingencies become determinable before adding any amount relating to the assumption of liabilities to the cost basis of the assets acquired.

To elaborate slightly on the correct treatment of contingent liabilities assumed in a sale of business assets, we will briefly review the major questions that both the Tax Court and the majority in the Federal Court of Appeal dealt with in this case.

Should the amount of an assumed contingent liability be included in the seller’s proceeds of disposition? In the case of a fixed liability the
answer to this question is easy. Assume a seller owes an amount to a third party, let’s say $10. If a purchaser offers to pay $100 for the assets and the seller uses $10 to pay off the liability, or the purchaser pays $90 and offers to assume the liability, the seller is equally as well off. Clearly the purchaser’s assumption of liabilities has value to the seller. The seller has been relieved of an obligation and the amount should be included in the seller’s proceeds of disposition. In this case all the judges recognized this and indeed Rothstein J. said in the Supreme Court that “[i]t is beyond dispute that, as a matter of principle, the assumption of a vendor’s liability by a purchaser may constitute part of the sale price and therefore part of the vendor’s proceeds of disposition ….”

Although the case for including the assumption of a fixed liability in the proceeds of disposition is clear, in this case Daishowa argued it should not have to include a contingent liability in the proceeds of disposition. It is hard to understand its reasoning. The fact that a liability might be subject to some contingency does not detract from the fact that relief from that liability has some value, in some cases a huge amount of value. The fact that a seller is prepared to accept an assumption of a contingent liability as consideration indicates it has value and presumably the seller has made a judgment about what that value is and it will be reflected in the amount of cash it receives. In this case Miller J. gave convincing reasons for holding that the assumption of contingent liabilities should form part of the proceeds of disposition of an asset and the majority in the Federal Court of Appeal adopted his conclusion and reasoning.

What amount should be included in the proceeds of disposition in respect of assumed contingent liabilities? The answer to this question is as obvious as the answer to the question of whether the assumption of contingent liabilities should constitute proceeds of disposition: the fair market value of those liabilities. What other possible answer is there? The Federal Court of Appeal held that the amount included in the proceeds should be the amount that the parties have agreed to assign to the contingent liabilities in their agreement of purchase and sale. This makes no sense. Indeed, it would seem to be inconsistent for the Court to hold that the seller must include the assumption of a contingent liability in the proceeds of disposition but then hold that the parties are free to assign whatever value they wish to such consideration. What if the

parties assign a value of zero? Moreover, if parties are allowed to assign values to assets without regard to their relative fair market value invariably they will be able to arbitrage the tax system since the assets might have different tax treatments in the hands of each party. Prices for individual assets will be chosen that reduce the overall tax liability of the transaction (given the tax position of each party) and then the resulting tax savings will be shared between the parties by manipulating the overall price charged.

Should the seller be able to deduct the amount of the assumed contingent liabilities? This was the taxpayer’s argument in Daishowa at both the Tax Court and the Federal Court of Appeal where the argument was relevant since those judges held that the assumed liabilities had to be included in the taxpayer’s proceeds of disposition. The taxpayer argued that by paying the purchaser with assets (by accepting a reduction in the cash consideration) to assume the liabilities, it had effectively paid off the liabilities and since the liabilities represented a current expense they should be entitled to a current deduction for that amount. Neither the Tax Court judge nor the majority in the Federal Court of Appeal took this argument very seriously. Yet, the argument must surely be correct.

One way to think about this issue is that if the seller had sold for cash only and then paid off the contingent liability (assuming this was possible) the seller would be able to claim a current deduction for the payment. Why should the tax treatment be any different if the seller discharges this liability by having the purchaser assume it? The seller has discharged the liabilities by paying with assets (by taking less cash for the assets). In these circumstances, if the seller would have been entitled to a deduction on payment of the liability, why should it not be granted a deduction at the time of the sale? Again, to the extent possible the assumption of a contingent liability should be treated the same as an all-cash sale.

Another way to think about this problem is that unlike the case of a fixed liability, with a contingent liability, although the seller has a liability that has had the effect of reducing the value of the business, it has not yet obtained a deduction for this decline in net wealth since the liability is too uncertain to be recognized for tax purposes. Therefore, upon the sale of the business assets, when the contingent liability will be valued, the seller should be entitled to a deduction for this decline in net wealth.

As the taxpayer argued in this case, if a seller has to include the value of the assumption of the contingent liabilities in proceeds of
disposition but is not given a deduction for the discharge of the contingent liability, it will end up paying tax on income it did not realize. A simple example illustrates this. Assume a taxpayer has an asset with a cost of $0 and a fair market value of $100. It also has an outstanding contingent liability valued at $100. Its net wealth position is zero. If the taxpayer sells the asset and pays off the liability its net wealth would remain unchanged and it would have no tax liability; the $100 gain would be offset by the $100 deduction for payment of the liability. But suppose it sells the asset to a purchaser who agrees in return to pay off the liability. Again the taxpayer’s net wealth has not changed. Yet if it is taxed on the $100 gain (the assumption of the liability being treated as proceeds of disposition for the sale) and it is not allowed to deduct the current liability that has been discharged, it will be taxed on a $100 change in its net wealth that it has not experienced. This absurd consequence was 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 related asset. But what if the liabilities are not considered to be embedded in the related asset?

In the Court of Appeal, in making the argument that Daishowa should be entitled to a deduction for the amount of the assumed contingent liabilities, the taxpayer noted that the amount would have been deductible as a current expense “if it had paid a sub-contractor to do the reforestation work”,74 or if it had paid the purchaser separately to relieve it of its reforestation liability.75 Justice Nadon did not find these analogies compelling. With respect to the first argument, he noted that Daishowa did not of course pay a subcontractor to incur the expenses and tax is imposed on what in fact the taxpayer did “not on what they might have done”.76 With respect to the second argument, in addition to pointing out that the taxpayer did not in fact make a separate payment to the purchaser, he noted that in any event such a payment would “likely be treated as capital, since it would provide to the appellant the enduring benefit of no longer having the reforestation liability associated with the forest tenure”.77

Of course the taxpayer did not do either of these things but the point of the examples was simply to reveal the logic of allowing a current

74 Daishowa-Marubeni International Ltd. v. Canada, supra, note 33, at para. 95.
75 Id., at para. 99.
76 Id., at para. 96.
77 Id., at para. 99.
They illustrate that there is no tax principle that would suggest the amount of the contingent liabilities should not be deductible. Further, there is no reason for treating the discharge of what would be a current expense as a capital expenditure. In the case, the taxpayer was going out of business. Paying to discharge the contingent liabilities would not result in the earning of income in future years. The expense had no value beyond the year. Hence it should have been treated as a current not a capital expenditure.

Should the purchaser be able to add the value of the assumed contingent liability to the adjusted cost base of the acquired assets and if so, when? This question was not dealt with directly by the courts in this case since the seller and not the purchaser was disputing a reassessment. However, the position of the purchaser was raised in the arguments. Again, there can be little doubt that the purchaser should be able to add the value of the assumed contingent liabilities to the adjusted cost base of the assets acquired. The assumption of the liabilities is part of the consideration for the assets. The more contentious issue is when should the seller be able to add the amount to the cost basis — at the date of the sale or when the liabilities are paid? Arguably the purchaser should be required to wait until the liabilities are paid before adding the amount to the adjusted cost base of the assets. This appears to be the well-established practice in Canadian tax law and the CRA's assessing policy. The tax policy rationale for this rule is that the eventual liabilities are indefinite and there is no reason why the addition to cost cannot wait until the actual costs are determined. Moreover, until the purchaser pays the contingent liabilities it has not incurred any additional burden and thus should not be able to increase the cost basis of the assets. The purchaser should have to add the expenses incurred in relation to the contingent liabilities to the cost basis of the assets instead of claiming them as a current expense since the expenses were not incurred as part of the purchaser’s business but as part of the consideration paid for the assets.

The problem of how to treat the assumption of contingent liabilities in the sale of business assets is a complicated tax issue for the reasons we set out at the outset of this comment on Daishowa. We have only touched on a few of the issues. In practice the assumption of contingent liabilities in an asset sale might involve delayed and contingent payments of the purchase price, indemnification agreements, placing part of the purchase funds in escrow, uncertainty about to which purchased assets the assumption of contingent liabilities relate, confusion about whether a
particular expense was incurred by the seller or purchaser, and much more. Nevertheless, Daishowa was an ideal case for the Supreme Court to establish the basic framework for thinking about all of these issues. Instead, it completely sidestepped a principled resolution of the basic issues and added a layer of complexity by inventing the notion that some contingent liabilities are “embedded” in assets.

III. ENVISION CREDIT UNION V. CANADA: METAPHYSICS IN PLACE OF TAX POLICY ANALYSIS

1. The Fate of an Egregious Tax Plan

In this case the taxpayer tried to arrange its affairs so that it could claim a tax deduction for the same expense twice. None of the judges who heard the case would allow it to do so. In some ways that is no surprise. Judges, even in most tax cases (but not all tax cases unfortunately), show concern for upholding the integrity of the law. However, in this case, perhaps as an indication of their desire to get the right result, each court offered different reasons in support of their holding denying the taxpayer the ability to effectively double dip with respect to its deduction of capital cost allowances.

The basic facts are simple. For good business reasons, namely, to take advantage of the efficiencies of a larger-sized business, two credit unions in British Columbia wished to amalgamate into (a corporation that subsequently became known as) Envision Credit Union. Normally, this would be a straightforward transaction for tax purposes. Section 87 of the Income Tax Act78 allows companies that amalgamate pursuant to corporate law to do so without tax consequences.

In the course of preparing for this particular amalgamation, some clever tax lawyer or accountant came up with an idea about how the amalgamation might be structured to allow Envision to claim tax deductions even though they had already been claimed by the predecessor companies.79

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78 Income Tax Act, supra, note 2.
79 In addition to being allowed to claim capital cost allowances that had already been claimed by its predecessor corporations, Envision also argued that as a result of its tax plan its “preferred rate amount” should be set at zero even though the predecessor corporations were
Under section 87 of the Act, when two companies amalgamate, one of the tax attributes that flows into the new company is the undepreciated capital cost of the depreciable properties owned by the predecessor companies. In this case, the predecessor companies had on their books depreciable properties that had an original capital cost of about $50 million. Over the years they had claimed as an expense over $30 million of capital cost allowances in respect of this property, and therefore the undepreciated capital cost of the property was about $20 million. Under section 87 the new amalgamated company would be deemed to have acquired this property at an undepreciated capital cost of $20 million and would have been required to continue depreciating it from this value. However, the tax planners came up with a scheme they thought would allow Envision to acquire this property at its original capital cost, $50 million. Thus Envision would be able to claim as an expense over future years the same $30 million capital cost allowance for the same properties that the predecessor companies had claimed.

The tax planning scheme depended upon two assumptions. First, that the taxpayer could arrange the amalgamation so that it did not fall within section 87. The strategy for attempting this was somewhat metaphysical. One of the conditions for section 87 to apply is that “all of the property … of the predecessor corporations immediately before the merger becomes property of the new corporation by virtue of the merger”. In an attempt to ensure that this condition was not satisfied, one term of the amalgamation agreement provided that at the precise moment of their amalgamation to form Envision the predecessor companies would transfer the beneficial interest in certain of their real estate properties to a newly created subsidiary corporation in exchange for shares of that corporation. Thus, although Envision would acquire the shares of this corporation, it could be argued that Envision had not acquired all of the property of the predecessor corporations “immediately before the merger” since the beneficial interest in the real estate properties that the predecessor corporations owned immediately before the amalgamation did not become property of Envision. Note that for this argument to prevail — and this is the metaphysics of it — the transfer of the beneficial interest to the subsidiary corporation and the amalgamation


carrying forward substantial preferred rate amounts. This would allow it extended access to a preferential rate of tax available only to credit unions. If Envision was successful in its argument relating to the capital cost allowances it was assumed that it would also be successful on this point.

80 Income Tax Act, supra, note 2, s. 87(1)(a).
would have to occur simultaneously. If the beneficial interest in the properties was transferred an instant before the amalgamation (and thus the predecessor corporations were holding the shares of the subsidiary corporation at the time of the merger) or an instant afterwards, then all of the property of the predecessors would have become the property of Envision upon the amalgamation and section 87 clearly would have applied.

The second assumption that the plan depended upon was that if section 87 did not apply to the merger then the new corporation would take over the depreciable properties of the predecessor corporations at their capital costs, namely, $50 million, and not their undepreciated capital costs, namely, $20 million; that is, that none of the capital cost allowance claimed by the predecessor corporations would flow through to Envision (as would be required by section 87). Somewhat surprisingly, it is not entirely clear how an amalgamation that does not meet the requirements of section 87 is taxed. The Act itself does not contain any specific provisions that would apply to an amalgamation that does not qualify under section 87. Under Canadian corporate law generally the theory is that upon an amalgamation of two or more corporations the amalgamated corporation is not a new corporation but is rather a continuation of the predecessor corporations. All the legal rights and obligations of the predecessor corporations become rights and obligations of the new amalgamated corporation. By reference to this corporate law doctrine, some tax commentators have expressed the view that even if section 87 does not apply, all of the tax attributes and accounts of predecessor corporations should flow through to a new amalgamated corporation. Others have suggested that since section 87 provides for a flow-through of tax attributes upon a qualifying amalgamation, if section 87 does not apply the tax attributes of the predecessor corporations should not flow through to the new corporation, or else section 87 would be redundant. Obviously, in support of this second assumption, Envision was relying upon this latter theory.

On the basis that both of these assumptions were correct, for its taxation years 2001 to 2004 Envision claimed capital cost allowance based on an opening balance of undepreciated capital cost of $50 million (the combined capital cost of the depreciable assets of the predecessor corporations). The Minister reassessed on the basis that Envision was only entitled to claim capital cost allowances on an opening balance of $20 million (the capital cost of $50 million minus the capital cost allowances claimed by the predecessor corporations).
The Minister asserted two alternative bases for reassessment (basically contradicting each of the taxpayer’s planning assumptions): first, section 87 applied to the transaction and therefore the undepreciated capital costs of the assets of the classes of depreciable property of the predecessors flowed through to the taxpayer and, second, even if section 87 did not apply, those tax attributes still flowed through based upon the corporate law continuation theory of amalgamations.

The Minister also argued that if she lost on both of those points, the General Anti-Avoidance Rule (“GAAR”) should apply. Since all of the judges held that the Minister was successful on one or the other of her two alternative bases for reassessment, or both, they did not deal with the application of the GAAR.

(a) Tax Court of Canada

In refusing to give credence to the taxpayer’s egregious tax planning, Webb J. (himself a former tax planner) held that the taxpayer had successfully dislodged the application of section 87 but that following general corporate law doctrine the tax attributes of the predecessor corporations flowed through to Envision in any event.

He held that property is transferred when the parties intend it to pass and in this case there was ample evidence that the predecessor corporations intended to transfer their beneficial interest in the real estate properties to the newly created subsidiary corporation at the very moment of the amalgamation. Thus, these properties, which were owned by the predecessor corporations immediately before the amalgamation, did not become Envision’s property by virtue of the amalgamation, as required by section 87. Section 87 thus did not apply to flow through the predecessors’ tax attributes, such as the undepreciated capital cost of their depreciable capital properties, to Envision.

In arguing that section 87 should apply, the Minister had argued that when two credit unions amalgamate in British Columbia, the new amalgamated corporation must by law acquire all of the property of the predecessor corporations. The Credit Union Incorporation Act (British Columbia), the Act that governs the amalgamation of credit unions,

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82 Id., at para. 38.
provides that “[o]n and after the date of amalgamation … the amalgamated credit union is seized of and holds and possess all the property rights and interests and is subject to all the debts, liabilities and obligations of each amalgamating credit union … .”

Justice Webb, however, said this provision “simply mean[s] that the amalgamated credit union would acquire the assets of the predecessor credit unions subject to any obligations of the predecessors.” Thus, the predecessor corporations were free to transfer property to a subsidiary corporation at the moment of the amalgamation. Although Envision acquired the shares of the subsidiary corporation, it did not “directly acquire” the predecessor’s beneficial interest in the assets transferred to that corporation.

Although Webb J. agreed with the taxpayer that section 87 did not apply to the merger, he went on to hold that the taxpayer could not step up the cost of the depreciable properties to their original cost of $50 million since the same tax result that section 87 dictated, namely, that the tax attributes of the predecessors flowed through to the taxpayer, was achieved by application of the well-known corporate law principle enunciated by the Supreme Court in Black and Decker. In that case the Supreme Court held that if the relevant corporate statute specifies that the amalgamated corporation is a continuation of the predecessors and not a new corporation, then the predecessors continue “without subtraction” in the amalgamated corporation. The legislation that applied to the amalgamating credit unions provided that amalgamating credit unions “are continued as one” and that “the amalgamated credit union … possesses all the property, rights and interests” of each amalgamating credit union. This wording is similar to language in Canadian corporate law statutes and is identical to that considered by the Supreme Court in Black and Decker. Therefore, Webb J. concluded that since in corporate law the two predecessor credit unions continued as one corporation all tax accounts “flow through” on an amalgamation even if section 87 does not apply. He stated that “[s]ince the predecessor companies continue ‘without subtraction’ in the amalgamated company [this was the language of Dickson J. in Black and Decker]”.

83 Credit Union Incorporation Act, R.S.B.C. 1996, c. 82, s. 23(b).
84 Supra, note 81, at para. 50.
85 Id.
87 Id., at 422.
predecessor companies] continued with the depreciation that each such company had claimed.\footnote{Supra, note 81, at para. 59.}

In reaching his conclusion Webb J. surveyed some of the literature setting out the competing theories about the tax treatment of amalgamations that did not qualify under section 87. He also noted the somewhat inconsistent positions that the CRA has taken over the years. Finally, he dealt with a series of arguments made by the taxpayer to the effect that if the tax accounts flowed through on an amalgamation that was not governed by section 87, then many aspects of that section were superfluous. Principally, Webb J. noted a number of provisions in section 87 that did not provide for a flow-through treatment such as the provision deeming the amalgamated corporation to be a new corporation for the purposes of establishing a new taxation year, rules allowing the adjusted cost base of some properties to be “bumped”, and rules deeming some properties to be acquired at their fair market value.

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Justice John Evans, writing for the unanimous Federal Court of Appeal, revealed his hand at the outset of his reasons. He stated that Envision faced “a daunting challenge” in arguing that “the Act permits essentially the same people to claim a CCA [“capital cost allowance”] of $30,876,207 twice over in respect of the same properties”. He went on, “[i]n my view, only the clearest statutory language could warrant a conclusion that Parliament intended such an anomaly.”\footnote{Id., at para. 31.}

Perhaps not surprisingly, the Court held for the Minister on both of the principal grounds she argued: section 87 applied to the case and even if it did not the tax attributes of the predecessor corporations still flowed through to the new amalgamated corporation under the continuation theory of corporate mergers.

The Minister also argued that all amalgamations of taxable Canadian corporations under corporate law fall within section 87. Justice Evans found it unnecessary to deal with this argument since on the facts of this case he held that both conditions of section 87 applied in that “all of the property … of the predecessor corporations immediately before
the merger … property of the new corporation by virtue of the merger”. He expressed some incredulity at the taxpayer’s argument that assumed that “[a]t the same metaphysical moment, the amalgamation caused the shares and the legal title to the surplus assets [the assets that had been transferred to the subsidiary] to become property of Envision, even though, on this theory of the timing of the transaction, the shares had not been owned by the predecessor corporations immediately before the amalgamation.”91 In determining that both conditions of section 87 were satisfied he ignored the formalities of the careful tax planning and looked at the substance of the transaction.

On the question of whether all of the properties of the predecessor corporations had become the property of the new corporation, Evans J.A. noted that after the merger Envision owned shares in a subsidiary corporation that in turn held the beneficial interest in the real estate that the subsidiaries had transferred to it. Therefore, it could be said that the property of the predecessors had become property of Envision. Merely the form of the property had been changed: “[a]ll the property owned by the predecessor immediately before the amalgamation can … be traced directly to property owned by Envision after the amalgamation.”92

On the question of whether the predecessors’ property became property of the new corporation “by virtue of the” amalgamation, Envision had argued that the shares of the subsidiary corporation became Envision’s property by virtue of a purchase and sale agreement and issuance of the shares. Justice Evans bluntly explained that insofar as all this happened “at the moment of amalgamation” the transactions were “part of a composite transaction, each component of which was intimately related to the merger”.93

In addition to holding that section 87 applied to the amalgamation of the credit unions, Evans J.A. determined that even if section 87 did not apply to the merger, the predecessor’s tax accounts would flow through to the amalgamated corporation. The wording of the amalgamating statute (in which merging credit unions “continue as one”) invoked the “continuation” model of amalgamation as set out by the Supreme Court in *Black and Decker* and under which Envision acquired the tax attributes of the predecessors, including the undepreciated capital cost of

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91 *Id.* at para. 33.
92 *Id.* at para. 39.
93 *Id.* at para. 41.
their depreciable properties. In supporting this holding, Evans J.A. closely followed the reasoning of the trial judge.

The taxpayer attempted to foreclose this reasoning by arguing that section 87 “is an exhaustive codification of the circumstances in which the tax attributes of amalgamating corporations flow through to the amalgamating corporation”.\(^{94}\) Thus by negative implication, and the interpretive presumption against redundancy, the Court should hold that the flow-through principle does not apply if section 87 does not apply. Justice Evans rejected this argument by reasoning that even though section 87 allows for the flow-through of many tax attributes, it is premised on the “new corporation” model of amalgamation, not the Black and Decker “continuation” model: “[t]here is thus no basis to imply a legislative intent that section 87 should occupy the field.”\(^{95}\) For the same reason, namely, that section 87 and Black and Decker are based on two different models of amalgamations, “[r]edundancy simply does not arise here, especially since section 87 pre-dates Black and Decker.”\(^{96}\)

\((c)\) Supreme Court of Canada

Like both lower courts, the Supreme Court held that the taxpayer’s tax plan was unsuccessful and dismissed Envision’s appeal. However, the Court held that the reasons given by both lower courts for this conclusion were wrong. Justice Rothstein, writing for the Court’s majority, himself and five of his colleagues, held that the section 87 requirements were satisfied, and therefore the tax attributes of the predecessor corporations flowed through to Envision, because of the specific language of the Credit Union Incorporation Act.\(^{97}\) the Act under which the credit unions were amalgamated. As a consequence of an amalgamation under the Act, that Act provides that the amalgamated credit union “is seized of and holds and possesses all the property” of each predecessor.\(^{98}\) Justice Rothstein stated that amalgamating credit unions cannot contract out of this mandatory consequence of an amalgamation. Hence, at the exact moment of amalgamation, Envision acquired all of the property of the predecessor corporations, including the real estate property that Envision

\(^{94}\) Id., at para. 48.
\(^{95}\) Id., at para. 62.
\(^{96}\) Id., at para. 66.
\(^{97}\) Credit Union Incorporation Act, supra, note 83.
\(^{98}\) Id., at s. 23(b).
then transferred to the subsidiary corporation pursuant to the purchase and sale agreements that accompanied the amalgamation agreement.\footnote{Envision Credit Union v. Canada, [2013] S.C.J. No. 48, 2013 SCC 48, [2013] S.C.R. 191, at para. 46 (S.C.C.).} Justice Rothstein supported his reading that the amalgamating Act mandated all of the property of the predecessor corporations to become property of the amalgamated corporation by reference to the statutory scheme of the Act and its policy objective of protecting creditors and the public.

In elaborating on the consequences of his holding, Rothstein J. acknowledged that given his reading of the British Columbia Credit Union Incorporation Act, since “effectively all corporate amalgamation statutes in Canada provide for continuity in respect of assets and liabilities”,\footnote{Supra, note 99, at para. 38.} this requirement of section 87 should be satisfied in all statutory amalgamations.

Justice Rothstein made it clear that he disagreed with the reasoning of Evans J.A. as a way of reaching the same result in this case. Justice Evans had held that Envision was seized of the property of the predecessor corporations since it owned the shares of the subsidiary corporation that in turn owned some of the property of the predecessor corporations after the amalgamation. Under the heading “Tracing Must Be Rejected”, Rothstein J. observed that “[i]t is a basic rule of company law that shareholders do not own the assets of the company” whose shares they own.\footnote{Id., at para. 57.} Envision therefore could not be said to be seized of the property owned by its subsidiary.

Since he held that section 87 applied in this case, Rothstein J. did not deal with the question of whether if it did not apply the attributes of the predecessors would flow through pursuant to corporate law as held in Black and Decker, and by both of the courts below.

Justice Cromwell wrote a concurring judgment in which although he agreed with the conclusion of the majority, he strongly objected to the majority’s interpretation of the relevant provision in the Credit Union Incorporation Act. He stated that it was “unnecessary and undesirable” to interpret the section in the way that the majority did and furthermore it might have unintended consequences.\footnote{Id., at paras. 62, 71.} He gave a straightforward-sounding reason for holding that section 87 applied. We set it out here in
his own words since the metaphysics of his point (and indeed of the whole tax planning arrangement) are a bit of mystery to us:

… at the moment Envision was created, the predecessor corporations ceased to have any independent legal existence. There was thus no point in time when … [the predecessor corporations] and Envision Credit Union existed as separate legal entities such that the … [predecessor corporations] could convey their property to Envision because, at the moment of amalgamation, only Envision was a separate legal entity. This is sufficient to fully answer the appellant’s appeal and I would stop the analysis there.\textsuperscript{103}

He then went on at some length about why the Court should not rest the case on an interpretation of the \textit{Credit Union Incorporation Act}; however, that was the sum total of his reasoning in holding for the Minister.

2. Analysis

Justice Rothstein begins his judgment in this case by reminding his readers, “[e]very taxpayer is entitled to order his or her affairs so that the tax payable is less than it otherwise would be.”\textsuperscript{104} This maxim was famously used in the notorious Duke of Westminster case to justify a flagrant tax plan and is repeated by every aggressive tax planner at every opportunity. But one wonders why? The assertion is perfectly true but perfectly meaningless. Of course taxpayers are entitled to order their affairs (within the law) to minimize their taxes; no one would dispute that. The only pertinent question is, have they done it? With respect to that question the maxim provides no guidance.

Since tax avoidance is an emotion-laden subject, it is interesting to note the reactions of the judges in this case. Justice Miller in the Tax Court of Canada was a tax planner (among other careers) before he joined the bench. Although he held against the taxpayer, he upheld the contrived scheme to dislodge the effect of section 87. Justice Evans, in the Federal Court of Appeal, a well-known public law scholar, appeared puzzled that anyone would take the tax planning scheme seriously. He had no difficulty finding that Envision was seized of the property of the predecessors that was transferred to a subsidiary corporation since that

\textsuperscript{103} \textit{Id.}, at para. 61.

\textsuperscript{104} \textit{Id.}, at para. 1.
corporation was wholly owned by Envision. As he noted, the transactions relating to the merger “merely changed the form of the predecessors’ property”. He devoted two short paragraphs to stating and justifying this finding. He also had no difficulty finding that the predecessor’s property became property of Envision “by virtue of the merger”: “the transactions under which Envision became the owner of the shares at the moment of amalgamation were part of a composite transaction, each component of which was intimately related to the merger”. This finding took him one paragraph. In the tax literature the importance of distinguishing between the owners of a corporation and the property of the corporation is made over and over again. Countless articles have been written about the fine art of determining when a series of transactions can be considered as one. Justice Evans alluded to neither of these difficulties. One suspects that he was aware of them, since he has sat on many tax cases, but felt that in egregious tax-avoidance cases it is important to look at the substance of what the parties have done in order to reach a sensible result. By ignoring widely accepted (but somewhat contrived) tax doctrine, his judgment presumably greatly unsettled the tax bar. In the Supreme Court Rothstein J. reverted back to a study of the metaphysics of the transaction in holding for the Minister. Even though the taxpayer lost the case, the tax bar was presumably comforted by the Supreme Court’s judgment.

Also somewhat parenthetically, it is difficult to understand Cromwell J.’s concurring judgment or why he felt so strongly that the Court should not decide the case based upon an interpretation of the amalgamating legislation. He wrote five pages and Rothstein J. three pages dealing solely with one another’s arguments. We are not familiar enough with the jurisprudence of either of these judges to speculate on what prompted the exchange, but anyone who thinks textualism is a good way of resolving legal disputes should read the exchange. One despairs at knowing who won the word game. However, here we’ll play the word game, briefly. Justice Cromwell gave his straightforward reason for holding for the Minister in the quote we refer to above. We don’t understand his reasoning, but somewhat oddly at the beginning of the paragraph we quote above he states that he reached his conclusion “on the basis set out in para. 50 of my colleague’s reasons”. Yet, as we understand the

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105 Supra, note 89, at para. 39.
106 Id., at para. 41.
107 Supra, note 99, at para. 61.
reasoning of Rothstein J. in para. 50 of his judgment, it depends critically on his earlier holding that the amalgamating statute mandated that the amalgamated credit union “is seized of ... all the property” of the amalgamating credit unions.

One has a good deal of sympathy for those who must resolve cases like this that involve complicated transactions that cut across a number of tax concepts and staggeringly detailed tax sections. In this case, as in many of these kinds of cases, the relevant provisions of the Act are rife with uncertainties. First, it is not clear why section 87 provides for essentially full rollover treatment for some amalgamations but not others. That is to say, it is not entirely clear what purpose is served by the qualifying conditions of section 87. In the tax policy literature, rollovers for corporate reorganizations are normally justified on the grounds that even though there has been a change in its form there is continuity in the taxpayers’ investments and thus most reorganizations do not trigger sufficient realization to justify treating them as a taxable event. This rationale clearly underlay the reorganization rules as they were originally enacted in the Tax Reform Act of 1972.108 However, since then the rules have been so substantially liberalized that now almost any corporate reorganization can qualify even though the affected taxpayers are not continuing with but are disposing of their interests. Indeed, most of the reorganization provisions are now essentially elective. If the parties elect in favour of rollover treatment then the affected properties are deemed to be disposed of at their cost amount and acquired at their cost amount. If the parties do not elect rollover treatment then all accrued gains and losses on the properties are recognized. Section 87 does not provide explicitly for an election for rollover treatment but arguably it should, and it should be made clear that if an amalgamation does not come within section 87 then the transaction will be a taxable event for both the shareholders and the predecessor corporations. The broader point is that as section 87 is now drafted it is unclear what purpose the qualifying conditions serve and therefore it is difficult to make sense out of them.

Second, another level of uncertainty arises in this area since it is unclear what amalgamating model section 87 rests upon. Is it based upon a “new corporation” model or a “continuation” (of the predecessor corporation) model of amalgamation? The answer to this question

assumed some importance in *Envision*, since if the section was found to be based on a new corporation model it allegedly strengthened the argument that an amalgamation that did not fall within section 87 would be based on a continuation model. However, aside from being irrelevant in answering the question of how non-qualifying amalgamations should be taxed, trying to decide what model of amalgamation section 87 is based upon is a mug’s game. Over the course of 40 years the section has been added to, subtracted from, and amended by countless different drafters, each trying to solve a specific problem in the application of the section and using different drafting styles. It is futile to imagine that one can generalize about the theory underlying the section by parsing through this mess. The leading textbook on corporate reorganization devotes two pages to lining up the provisions in section 87 from which competing inferences can be drawn about which model underlies the section.\(^\text{109}\)

Just incidentally, somewhat oddly, even though the provision is clearly intended to provide a rollover for qualifying amalgamating corporations, the section does not provide that the predecessor corporations are deemed to dispose of their assets at their cost amounts. Did the drafters assume that in an amalgamation the predecessor corporations continued in the amalgamated corporation (even though the drafting of the provision pre-dated *Black and Decker*) or that such a result could be inferred from the fact that the section provides that the amalgamating corporation acquires the assets at their cost amount?

A third level of uncertainty arises over how amalgamations that fall outside of section 87 are taxed. This of course was an issue that both lower courts dealt with in this case, but was left unanswered by the Supreme Court. It is a pity that it did not deal with the issue since it is of some importance. In deciding against the taxpayer on this issue, both of the lower courts found that the tax attributes of the predecessor corporations flowed through to the amalgamated corporation. The main reason for so holding was that in corporate law, following *Black and Decker*, and based on the wording of corporate statutes, the property and liabilities of predecessors continue into the amalgamated corporation. But it is not obvious why tax law should follow corporate law in this respect. In *Black and Decker* the Supreme Court held that under the relevant corporate statute the amalgamated corporation was a continuation of the amalgamating corporations and thus the criminal liability of

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one of the predecessor corporations became the criminal liability of the amalgamated corporation. In the context of corporate law, this holding makes sense since, as the Court noted, otherwise a corporation “by the simple expedient of amalgamating with another company could free itself of accountability for acts in contravention of the Criminal Code”\(^\text{110}\). However, that consideration is certainly not relevant in terms of tax principles. A more sensible default position for tax purposes would appear to be that since there is a substantial change in the nature of the investment, in an amalgamation there is a disposition at both the shareholder and corporate level. The argument for this is particularly strong given that section 87 provides for a rollover for tax purposes for qualifying amalgamations. Altogether aside from canons of statutory interpretation, what is the sense of having an income tax that provides two types of rollovers for amalgamations — one well defined in section 87 and the other completely undefined and that provides no answers to a raft of the most basic tax questions pertinent to an amalgamation such as what happens if the two predecessor corporations have different year-ends? Moreover, if the corporate concept of continuation were to be taken seriously, does that mean that the classes of depreciable assets of the predecessor corporations continue to be depreciated separately? Do the two corporations continue to file separate tax returns? These and countless other questions have to be answered if there is going to be a flow-through of tax attributes on an amalgamation. These questions and many more are answered in section 87; none are answered if there is assumed to be a flow-through of tax accounts and attributes outside of section 87.

Certainly the taxpayer’s position in this case was odd. It argued that while the predecessor corporations should be treated as having disposed of their assets at their tax cost amount, the amalgamating corporation should be treated as having acquired them at their original cost basis. It is hard to imagine the circumstances under which that would make any sense. Even aside from sensible tax considerations, how could one justify adopting one tax attribute from the predecessor corporations, namely, the cost basis of the assets, but not another, namely, the capital cost allowances they had claimed?

As we noted above, these and other uncertainties in this area make resolving unanticipated problems especially difficult and one can only

\(^{110}\) Supra, note 86, at 418.
sympathize with the problem solver. However, in this particular case we have no sympathy for the taxpayer or the courts. The position of the taxpayer was absurd by any standard. The time of the courts should not have to be taken up with these kinds of cases. It is a testament to the sorry state of Canadian tax jurisprudence that anyone would think they had a chance of claiming the same expense twice with such an egregious tax plan.

Instead of beginning his judgment by noting that “[e]very taxpayer is entitled to order his or her affairs so that the tax law is less than it otherwise should be”, Rothstein J. should have begun his judgment by noting “tax planning … produces nothing of value … . No new medicines are found, computer chips designed, or homeless housed through tax planning”. Indeed, since tax planning imposes costs on others “it is worse than worthless”. He might have continued by explaining that in interpreting the Act the Court was going to assume that Parliament is “made up of reasonable people pursuing reasonable purposes reasonably” and that if an argument cannot rest upon that minimal assumption counsel should not waste the time of the Court making it.

IV. QUÉBEC (AGENCE DU REVENU) V. SERVICES ENVIRONNEMENTAUX AES INC.: A MISSED OPPORTUNITY TO RESTRICT AFTER THE FACT TAX PLANNING

The Supreme Court’s unwillingness to engage with the interesting and important tax issues before it continues in Québec (Agence du Revenu) v. Services Environnementaux AES inc. and Québec (Agence du Revenu) v. Riopel. In common law contract law, whether the courts should intervene to adjust, or rectify, a written contract entered into between the parties that may not reflect their original intentions is a complex issue with a long and rich history. Rectification is a restitutary remedy that allows parties to a valid contract to appeal to the

112 Id.
equitable jurisdiction of a court in aid of an adjustment to their written agreement to ensure it conforms to their original intent. Generally speaking, courts are willing to grant the requested adjustment on the grounds that the parties reached an understanding but in translating the understanding to writing, a mistake was made. The challenge in determining when an adjustment should be permitted is in distinguishing basic writing mistakes, for example, the failure to add a period to a number (e.g., $1000.00 becomes $100000) from circumstances where the oral agreement or understood intentions of the parties may be much further from the written contract. Rectification might sensibly be permitted in the former instances, but not in the latter. The key determination is where the line should be drawn.

In Quebec, the remedy of rectification has a less storied history. The Civil Code of Québec governs matters of private law, to the exclusion of common law and equity doctrines. Nevertheless, the Civil Code of Québec includes a provision that enables courts to adjust a contract when it does not reflect the intention of the parties. In particular, Article 1425 of the Civil Code of Québec provides, “[t]he common intention of the parties rather than adherence to the literal meaning of the words shall be sought in interpreting a contract.”  In recent years there has been an ongoing debate in Quebec of whether this provision applies only to allow for the correction of obvious basic writing mistakes or whether it incorporates a broader remedy into Quebec civil law analogous to the remedy of rectification as applied by some common law courts.

The use of rectification as a mechanism for adjusting the underlying contractual arrangements in tax cases is a relatively new development. In the common law provinces, taxpayers began relying on rectification in the mid-1990s, with greater proliferation in the 2000s following the controversial decision of the Ontario Court of Appeal in Juliar.

In AES, the Supreme Court could have seen itself as tasked with distinguishing contracts that are appropriately rectified in tax cases from those that are not. Instead, the Court preoccupied itself only with the issue of whether the civil law allows a remedy analogous to rectification without clarifying the precise contours of that remedy and whether it is the same in Quebec and the common law provinces.

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1. Facts

The Supreme Court had two sets of facts before it in AES: the facts from **AES**\(^{117}\) and the facts from **Riopel**.\(^{118}\) The cases, both of which addressed rectification in the civil law context on tax facts, were joined before the Supreme Court. In AES, the taxpayer attempted a tax-deferred reorganization but was mistaken about the cost base of the shares exchanged. To provide a little more detail, Centre technologique AES Inc. (“Centre”) was a wholly owned subsidiary of Services environnementaux AES Inc. (“AES”). AES decided to sell 25 per cent of its shares to Centre. To effect the sale, the companies agreed they would undertake a tax-deferred exchange of shares under section 86 of the *Income Tax Act* and sections 541 and 543 of the Quebec *Taxation Act*.\(^{119}\) AES understood that it had cost of a little over $1.2 million in its shares of Centre. As a result, it received a promissory note equal to its cost as part of the reorganization. AES later discovered that its cost was only a little over $95,000. The CRA reassessed and treated AES as having realized a capital gain of $840,770, namely, the amount by which the promissory note it received from Centre exceeded the real cost of its shares, given the capital gains inclusion rate.

In **Riopel**, the taxpayer also requested rectification of a contract for the sale of shares. The taxpayer, Mrs. Archambault, and her husband wanted to restructure their investments with the objective of extracting some of the value held in a related company without tax implications. Their advisors described a plan for transferring shares, merging related companies, and redeeming the shares, that would have achieved that objective. Ultimately, however, the couple’s advisors did not undertake the reorganization in the fashion described. The result was that the redemption of the taxpayer’s shares was taxable. In an effort to fix the reorganization error, the advisors modified the restructuring without consulting Mrs. Archambault and her husband or explaining their mistake.


\(^{118}\) Supra, note 114.

\(^{119}\) CQLR, c. I-3.
(a) Trial Court

At trial in AES, the Agence du revenue du Québec argued that the Superior Court did not have jurisdiction over the issue, that articles 1400 and 1407 of the *Civil Code of Québec* prevented an action for rectification, and furthermore that the Code itself did not provide a remedy analogous to the common law rectification remedy but only allowed the Court to correct obvious transcription errors, and that the original documents appropriately reflected the parties’ intent. In a nine-paragraph decision, Borenstein J. concluded that the facts of the case militated in favour of rectification.

In contrast, at trial in Riopel, the Quebec Superior Court denied rectification. Justice Nantel determined that while Mrs. Archambault and her husband had agreed to a tax-free reorganization of their affairs, the plan was not implemented as described. As LeBel J. summarizes in his review of the decision, “[t]he trial judge found, first, that no agreement of wills that would have led to the formation of a contract had resulted from the meeting of September 1, 2004 between the parties and their advisors.” Justice Nantel determined that the discrepancy between the original plan and the plan as executed might justify annulling the contract, and noted that that remedy would undoubtedly create a host of new tax-related problems. She therefore denied the request for rectification on the grounds that the error was not clerical in nature, but rather was an error affecting the substance of the transaction’s structure. In a succinct judgment, she additionally held that the common law doctrine of rectification should not be transposed into civil law.

(b) Quebec Court of Appeal

The Quebec Court of Appeal allowed rectification in both AES and Riopel. The Court in AES, in a judgment authored by the Court, permitted rectification of the contract on the grounds that courts can correct a discrepancy between the common intention of the parties and the intention as reflected in the contract, relying on article 1425 of the

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121 Article 1400 addresses error that vitiates consent and 1407 addresses the remedial consequences of vitiating the consent of one of the parties.
122 Supra, note 114.
123 Id., at para. 19.
Civil Code of Québec, as long as the request is legitimate and third parties’ rights are not unduly affected. As a result, the Court did not find the civil law to be a barrier to contractual rectification in these circumstances.

In a judgment rendered a couple of months after AES, the Quebec Court of Appeal permitted the appeal in Riopel CA,125 also determining that article 1425 of the Civil Code of Québec enables rectification. Following AES, and excerpting extensively from that decision, the Court of Appeal determined that the error in Riopel was a discrepancy between the common intention of the parties and the intention reflected in the contract itself.

(c) Supreme Court of Canada

At the Supreme Court, Revenue Québec, supported by an intervention by the Attorney General of Canada, argued that the civil law precluded rectification. The Supreme Court dismissed the appeal, determining that article 1425 allows for parties to have their written instruments amended to reflect their original agreement.

The Court did not engage in an extended discussion of the scope of rectification. The first paragraph of LeBel J.’s decision includes the conclusion that: “[t]he intention [of the parties] was that their agreements would have no tax consequences.” On one level, that statement elides the issue that has been the focus of much of the discussion of rectification, post-Juliar, namely, what is required to understand the parties’ intent, and how specific does that intent have to be? The Supreme Court concludes that “[t]he common intention of the parties was expressed erroneously in all the writings prepared to carry out the tax plans on which they had agreed.”126 Justice LeBel proceeds with a caution to taxpayers that they, “should not view this recognition of the primacy of the parties’ internal will — or common intention — as an invitation to engage in bold tax planning on the assumption that it will always be possible for them to redo their contracts retroactively should that planning fail.”127 Without a sense, however, of how specific the parties’ intentions must be, and how far the written agreement is permitted to be

125 Supra, note 114.
126 Id., at para. 53.
127 Id., at para. 54.
from those intentions, it is hard to imagine how a taxpayer will know whether or not she is engaged in bold tax planning.

Although the scope of *Juliar* was expressly raised by the Attorney General, the Court elected to limit its discussion of that decision on the grounds that it did not have common law rectification before it for consideration. However, quixotically, LeBel J. does note that *Juliar* appears incompatible with the Supreme Court’s non-tax jurisprudence on common law rectification.\textsuperscript{128}

2. Analysis

AES presented the Supreme Court with its first chance to look at the role of rectification in the tax context. However, it restricted its holding to providing that the civil law allows for a remedy like rectification. It refused to provide guidance on the pressing issue for tax law: when should a taxpayer be able to revisit the design of a flawed tax plan?

On the issue of whether the civil law permits rectification, the Supreme Court’s decision resolves uncertainty born of two lines of lower court decisions.\textsuperscript{129} In *Brochu v. Placements Donald Brochu inc.*,\textsuperscript{130} for example, the Quebec Superior Court permitted rectification of an estate freeze. In *Brochu*, the taxpayer believed there was roughly $1 million in the company’s capital dividend account. The company declared a $1 million dividend and elected to pay it out of that account. Ultimately, the capital dividend account was determined to have closer to $750,000 in it, and the taxpayer was reassessed and held to owe tax on the excess distribution. The Court allowed the taxpayer to repay the excess to the company, ensuring that the distribution of the amounts in the capital dividend account could be received tax-free. A contrasting line of decisions, however, held that rectification was not appropriate under civil law.\textsuperscript{131}

\textsuperscript{128} *Id.*, at para. 55.
\textsuperscript{129} The tension between the common and civil law on the issue of rectification in the tax context was the subject of the article by Boidman et al., *infra* note 131, who argued that the distinction between the common law of rectification and the view that the *Civil Code of Québec* precluded rectification measures, “creates a totally different playing field as between persons in the common-law provinces and those in Quebec, and one that is manifestly inappropriate from a national tax policy perspective, particularly in light of the recent movement toward bijuralism” (at 146-47).
So, the Supreme Court resolved the issue of whether rectification is permitted in civil law, although by distinguishing the civil law remedy from the common law remedy, it left uncertainty about the scope of rectification in both civil and common law. Additionally, the Supreme Court left unaddressed the harder question of where the line should be drawn between rectifiable and non-rectifiable contracts in the tax context. The uncertainties in the area of when contracts should be rectified in the tax context have been laboriously documented by tax practitioners and scholars.132

Much of the uncertainty about rectification in the tax context has arisen as a result of the Ontario Court of Appeal decision in Juliar. In Juliar, the Ontario Court of Appeal, following the lower court decision, allowed the taxpayers to adjust their contractual arrangements. The parties had transferred shares to a corporation in exchange for promissory notes that equalled the value the parties believed to be their cost in the shares. If their assumption about the cost of the shares had been accurate, the transaction would not have attracted tax. In fact, the promissory note was worth more than the cost of the shares, and the taxpayer was reassessed as having received a taxable deemed dividend. The taxpayers could have undertaken the transaction differently, by transferring their shares in exchange for shares: a transaction that would have been tax-deferred. The trial judge found the evidence that the parties wished the transaction to be undertaken in a way that deferred tax clear and convincing. The Ontario Court of Appeal, affirming the lower court decision, held that the contract could be rectified. The Revenue Agency expressed concern about the approach taken in Juliar and released a notice confirming that they would oppose applications for rectification that asked the Court to undo an intended transaction and put in place a new one formed after the original transaction.133

Since Juliar, courts have grappled with the appropriate boundaries on the equitable remedy of rectification and the instances where

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133 See Income Tax Technical News No. 22 (January 11, 2002), response to Question 5 under the “Rectification Orders” section.
taxpayers have requested rectification from the courts have proliferated.\textsuperscript{134} In some decisions an expansive approach to rectification has been followed. For example, in Snow White,\textsuperscript{135} the taxpayer entered into a production services agreement with the object of qualifying for the film production tax credit. Ultimately, the contract referred to a party as the copyright owner, when it turned out that person did not own the copyright. The credit was denied by the CRA. The parties sought to rectify the agreement by substituting the name of the party to the contract without the copyright ownership to the name of the person who in fact held copyright. The British Columbia Supreme Court permitted the rectification, even though, as Joel Nitikman suggests, “[i]t could hardly be said that the new party had had a continuing common intention to be a party to the contract, or else it would surely have been a party.”\textsuperscript{136}

Another line of cases courts have read Juliar more restrictively. For example, in a thoughtful recent decision Graymar Equipment (2008) Inc. v. Canada (Attorney General),\textsuperscript{137} authored by Brown J. of the Alberta Court of Queen’s Bench (now Brown J.A. of the Alberta Court of Appeal), a former faculty member at the University of Alberta, that was rendered after AES, the Court denied a rectification request on the grounds that the taxpayer did not prove a tax minimization objective. The taxpayer (a partnership) in Graymar inadvertently left a shareholder loan outstanding with the result that the partners of the partnership were required to include a portion of the outstanding loan in their income. The taxpayer sought to backdate a resolution that would settle the loan retroactively. The Court in Graymar rejected the argument that tax minimization is an element of every transaction and therefore must have been an intention of the parties in the loan transactions. Instead, Brown J. carefully circumscribed the scope of Juliar, distinguishing between asking the question “what did the parties originally intend to do?” from the question “what would they have done had they known about this unanticipated tax outcome?”\textsuperscript{138} We are heartened by Brown J.’s thorough

\begin{footnotes}
\item[134] See Brown & Cockfield, supra, note 132, at 570.
\item[136] Nitikman, supra, note 132, at 962.
\item[138] Id., at para. 71.
\end{footnotes}
review of the case law and underlying principles, alongside his tendency
to consider the consequences of his decision, “[t]o hold otherwise — that
is, to skate over the requirement, as Juliar does, of showing the intention
underlying the original transaction — would effectively render the CRA
(and, by extension, Canadian taxpayers) the insurer of tax advice
providers. This is undesirable.”

The Supreme Court had an opportunity, given these conflicting lines
of cases, to resolve the issues they raise, including whether tax cases
should be treated differently than other rectification requests and how the
scope of cases where rectification is requested should be limited. Courts
have, at least in some instances, expressly distinguished the rectification
cases with tax subjects from those with non-tax subjects. For example, as
Masuhara J. states in Fraser Valley, “[i]n tax cases rectification is
granted to rectify documents that are inconsistent with the expressed and
agreed intent of the parties to a contract. Intent is relevant, because where
intent is common and continuing it forms a part of the true agreement
between the parties to a contract.” Similarly, and perhaps even more
obviously, Campbell J. in Di Battista states, “once the Court is satisfied
that the true agreement between the parties (which is based on the
transaction not attracting or at least minimizing income tax) is frustrated”
rectification can be granted.

As a general matter, our view is that there is no need for judges’
approach to rectification to be the same in tax cases and in non-tax cases.
One of the responsibilities of judges in resolving tax cases is to
characterize the transaction. The purpose of that characterization exercise
is, most fundamentally, to adjudicate whether or not the taxpayer has
income, appropriately subject to tax. This requires examining the
economic substance and effect of the transactions undertaken by the
taxpayer. This purpose is presumably different from the exercise of con-
struing contracts in other settings, where the fundamental point of
construing the contract is not to make sense of whether or not the
taxpayer has income. When the fundamental purposes of interpreting a
contract for tax purposes are accepted, the discord between the tax

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139 Id., at para. 72.
141 Id., at para. 41.
(Ont. S.C.J.).
rectification cases and the “other” rectification cases in and of itself is not troubling.

The troubling aspect of the tax rectification cases is the unwillingness of the judges in cases from *Juliar* forward to articulate an appropriate approach to distinguishing cases that merit rectification from those that do not. Drawing such a line is, given the absence of a principled ground for distinction, a necessarily pragmatic task. That exercise should take as its foundation the purpose for distinguishing between rectifiable and non-rectifiable cases the purpose of the income tax legislation: to tax income. In cases where the taxpayer has received economic income as a result of the arrangements undertaken, the agreement should not be rectified even if the parties had initially hoped for more favourable tax treatment. The taxpayer has received income and the income tax legislation is appropriately being applied to tax it. This approach ensures the appropriate result: that taxpayers are taxed when they have income and they are not taxed when they do not.

Enabling rectification in only the narrow cases where the agreement does not reflect the intention of the parties and might have as a consequence taxation for the taxpayer where no economic income was received (for example, where the taxpayer was paid $1000.00 but the agreement mistakenly said $100000) has the additional benefit of preserving public resources. Assessing taxpayers and bringing cases through the superior courts is expensive and unproductive. Where possible, and especially where the taxpayer has received economic income, it makes sense to design tax rules in a way that minimizes court time. The broader scope for rectification, which enables a taxpayer to bring a claim for rectification where the parties hoped for a different tax result (generally tax deferral or non-taxation), creates an incentive for taxpayers to bring costly claims through the court system where the hardship for the taxpayer (given that they have economic income) is not obvious. In cases like *AES* and *Riopel* it leaves the public as the insurer of bad accounting and legal advice.

The Supreme Court had the ideal cases in front of them to clarify the appropriate approach to rectification in tax cases. It also had an opportunity to clarify the relationship between the civil and common law approaches to rectification. Instead of resolving these issues, the Court left them for another day. Too bad. Undoubtedly, given the incentives the continued uncertainty about the scope of rectification creates for taxpayers to seek after-the-fact adjustments to their tax plans, the Supreme Court will be revisiting this issue again in the future.