



VALUING NON-CAPITAL TAX LOSSES IN BUSINESS ACQUISITIONS

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ACQUIRING FIRMS WITH TAX LOSSES - OVERVIEW

The following article is a pragmatic but cursory consideration of Canadian tax loss deductibility rules and specifically those situations when these losses may be valuable to a subsequent business owner. The Acquisition of Control¹ rules are both detailed and intricate. The following is only meant to serve as a generalized overview of those circumstances of when you, as business vendor, might expect your non-capital tax loss pools to generate additional compensation in a business sale - or, conversely, when you, as business purchaser, might expect to gain additional value via the utility of acquired non-capital losses in the target firm.

Contrary to the approach that most writers use for this subject (which is to enumerate a long list of criteria that will disqualify the use of acquired losses by the subsequent business owner), we will focus instead upon those circumstances when the Canada Revenue Agency (CRA) will allow the deduction of acquired losses. The reader should be forewarned, however, that this is probably the exception to the rule – there are numerous criteria that will negate the deductibility of acquired taxes losses, and expert tax advice should be sought out for each specific case.

THE INTRINSIC VALUE OF TAX LOSS POOLS

Here we are concerned primarily with non-capital tax losses, and specifically those generated from Business Income^{2,3}. Non-capital losses are valuable because, under

¹ The official descriptor used by the Canada Revenue Agency is “Acquisition of Control, but we will use this interchangeably with the term “Change of Control”, indicating a new party now controls the firm.

² Non-Capital Losses incurred from Property or Limited Partnerships will not be available for deduction upon the transfer of control.



normal circumstances, they may be ‘carried-back’ three years against previously recorded positive taxable income and may be ‘carried-forward’ as a deduction against future taxable income for up to twenty years. Upon a Change of Control, acquired losses may not be ‘carried-back’⁴, but they are still deductible against the future twenty years of taxable income under very specific circumstances.

Acquisition of Control (defined below) becomes the “trigger” upon which the future deductibility of the loss pools is called into question. In the absence of a Change in Control, there is no reason to believe that the status of these pools (including non-capital, net capital and SR&ED if these exist) would change. Moreover, it does not matter whom the acquiring “Person” or “Group of Persons” is (assuming the acquirer is arms-length and not associated with the existing controlling Person(s)). It could be a single corporation, or a group of associated corporations; an individual or a new group of related individuals or a partnership. Our particular interest here, however, is when the control of a firm with a non-capital tax loss pool changes and the acquiring entity is a taxable Canadian corporation that has had a consistent history of profitable operations and positive taxable income that is likely to continue. Under these circumstances is it possible that a transfer of the tax losses from the target firm to the cash-taxable firm *may* be allowable. Such a transfer would provide the cash-taxable acquiring firm with an effective tax shield reducing future cash tax outflows.

ACQUISITION OF CONTROL (CHANGE OF CONTROL)

Acquisition of Control as described by the Income Tax Act (ITA) occurs when a Person (which, as defined by the ITA, also includes a Corporation) or Group of Persons, takes de Jure control of the tax loss firm. For all intents and purposes, this means the acquirer gains the right to exercise the majority of votes in the target firm and thereby elect the majority of the acquired firm’s board of directors.

³ Net Capital Losses are effectively lost upon a Change of Control, they are no longer deductible after this event and therefore become worthless.

⁴ For example, if a firm with tax losses was acquired and amalgamated with a profitable firm that had positive taxable income in the prior three years, the acquired tax losses would NOT be allowed to be carried back against the amalgamated firm’s previous three years in order to generate a tax rebate.



DEDUCTIBILITY OF NON-CAPITAL LOSSES

The ITA s111(5)(a)(i) requires that, in order for the previous non-capital losses to be deductible subsequent to a Change in Control, the acquired business must be carried on with a reasonable expectation of profit. In the absence of an expectation of profit, these losses would no longer be deductible and would become worthless. Therefore, purchasing a defunct business only for the use of its existing tax losses would not be allowed as it would be argued that no reasonable expectation of profitability could be expected (and even if this argument were not successful, the GAAR would come into play, as is subsequently described).

Also, even with the expectation of profitability, in order for the non-capital losses to be deductible in future years the “streaming rules” require that the future taxable income must be derived from ‘*similar*’ businesses. It is not, therefore, possible to purchase a firm that had generated a non-capital loss pool in the courier business, for example; transform the services into a truck repair depot and expect to use the pre-acquisition losses to reduce taxable income from the repair business. What constitutes a “similar” stream of income is not defined by the ITA, but case law suggests that the primary activity by which the firm had generated the losses must be virtually the same as the post-acquisition business.

GENERAL ANTI-AVOIDANCE RULES

The General Anti-Avoidance Rules (GAAR) in the ITA are aimed at attempting to prevent any transactions the primary purpose of which is to avoid taxation rather than to serve any bona fide business purpose. The prime example, with respect to the Acquisition of Control rules is purchase of a business solely for the application of its non-capital tax losses. Notwithstanding the GAAR, it would first be necessary that such a target firm could still have a reasonable expectation of profit and that the future taxable



income that was to be applied against the losses were “similar” in nature to the loss income. An example will greatly simplify the explanation of GAAR.

Imagine a successful and cash-taxable Human Resources Placement and Consulting firm (the Acquirer) becomes aware of the increasing difficulty of one of its competitors (the Target). The Target’s solvency is called into question and proportionately large non-capital losses are accrued. The Acquirer has a dominant market position and already has a solid relationship with all of Target’s clients. Acquirer makes an offer to purchase 100% of Target shares with the understanding that:

- None of the Target staff are to continue under the new ownership
- All the Target leased locations will be closed and lease terminations negotiated
- The Target brand/trade name will be discontinued
- The physical assets of Target are insignificant
- The Target client list does not contain any major customer with which Acquirer does not already have a preferred relationship

Acquirer intends to keep the Target legal entity as a going concern and assign various placement contracts to Target until such time as all the non-capital loss carry-forwards have been consumed. These profitable placement contracts would have been earned by Acquirer regardless of whether Target was taken over or not.

Under these circumstances, the GAAR⁵ would probably disallow Acquirer from gaining any tax shelter from the Target non-capital loss pools. It is quite apparent that the only purpose Acquirer has in gaining control of Target is in the utilization of the tax shield. There is no valid business reason for Acquirer making the acquisition as might be argued if the goodwill or market visibility in the Target name was sought after, or the expert staff or new client relationships were the motivation behind this purchase.

⁵ Specifically, section 245 of the ITA.



VALUATION OF NON-CAPITAL LOSS CARRY-FORWARD POOLS

Assume all the hurdles have been met – that the target firm has a reasonable expectation of profit, that there is a ‘similarity’ in income streams of pre and post-acquisition business and that the GAAR will not apply. In those cases, the value of an acquired non-capital tax pool is dependent upon the size of the pool, the effective tax rate of the cash-taxable entity and the expectation of future taxable income.

Often the expectation is that the acquired firm will be amalgamated with acquiring firm and the tax losses are absorbed into the combined entity. In such a case it would be the expected taxable income of the combined entity that would define how much the acquired loss would be worth. On occasion, this is not the case, however, with the acquired firm remaining legally autonomous (perhaps after being re-financed by the new parent). In this case, it would be the revised taxable future income of the target that would determine how valuable the tax loss pool is.

Imagine, for example, a target with a \$2 million non-capital accumulated loss⁶, with an effective combined provincial and federal tax rate of 32.3%. The acquirer has conducted a detailed analysis of the inherent risk of purchasing 100% of the shares of the target and concluded, inclusive of the tax pool considerations, that a 15% discount rate is called for. The target entity is to remain autonomous of the new parent, and, after some re-financing is expected to begin generating taxable income immediately following the acquisition.

Acquisition Date is	Expected	Balance of Non-	Implied Cash	Present Value of	
June 30, 2006	Taxable Income	Capital Loss Pool	Tax Shield @	Cash Tax	Cash Taxes
			32.3% Tax	Savings @ 15%	Payable
			Rate	Discount	
30-Jun-2006	-	2,000,000			
31-Dec-2006	375,000	1,625,000	121,125	112,950	0
31-Dec-2007	500,000	1,125,000	161,500	130,956	0
31-Dec-2008	980,000	145,000	316,540	223,195	0
31-Dec-2009	1,350,000	-	46,835	28,716	389,215
				495,817	

⁶ And here we are implicitly assuming that these losses will not expire or be limited by the 20 year maximum carry-forward prior to being fully applied against future taxable income.



One can see in the table above that, under these circumstances, the presence of the existing \$2M non-capital tax loss pool eliminates the requirement to pay Part I taxes for the first 2.5 years after acquisition and then provides a partial shield against the 2009 tax year. As a result, the present value of the tax loss pool is approximately \$496K. Under these circumstances an acquirer would be willing to offer an additional half-million in compensation for the existence of the tax losses. Contrast this with the potential acquirer who might be just as optimistic over the target's future in terms of net cash generation, but intends to switch the nature of target's primary activity to some other industry. In that case, the tax pool would become worthless as the "similar" income streaming rules would not be met.

CONCLUSIONS

The Acquisition of Control rules are complex. A potential purchaser should not simply assume that the tax shield loss-carry-forward benefits the existing owner has been enjoying will automatically accrue to the new owner. Under the right circumstances, however, the loss tax pools can become valuable assets to the potential acquirer.