Vol. 2 No. 2 July/August 1998

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Marmer Penner Newsletter

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No Asset and No Income May Not Mean No Value

If every cloud has a silver lining, every loss may have a potential gain lying in its midst. This optimistic philosophy should be borne in mind when valuing a corporation with unused losses, whether or not these losses have yet to expire.

Business losses of a corporation can be applied against its income for the three previous years or carried forward to apply against income in the following seven years. Accordingly, if a corporation has prior income from the last three years or virtual certainty of future income, its losses have a value based on the corporation's tax rate. The next best thing to having unused losses is the ability to utilize someone else's losses.

In order to acquire the shares of a "Lossco" for the purposes of utilization against the acquirer's income, the operations which created the loss must be "the same or similar business" of the acquirer. Furthermore, the operations of the Lossco may not have been discontinued.

Consider the following example:

Lossco manufactures widgets and has incurred $1 million of losses in the last two years. Profitco is in the same business and has sufficient income to utilize these losses. Profitco pays income tax at a 40% rate. Accordingly, the shares of Lossco, which may be valued based on an asset approach due to its unprofitability, have an unrecorded asset which may be worth as much as $400,000 (40% of $1 million of losses) to a *willing buyer. Practically speaking, shares of a loss company trade at a discount from the pure value of the unused losses but the value may still be significant.*

It was noted above that in order for losses to be transferable, the business may not have been discontinued. Does this imply that a Lossco that has been abandoned has lost any of its possible tax value to the shareholder? Not necessarily. Consider the following example:

Lou is a shareholder of Lossco which carried on the business of widget manufacturing. Between 1990 and 1995 Lou advanced $1 million to the corporation to finance its operations which never succeeded. At the end of 1995 Lossco discontinued its operations, sold its remaining assets, and was unable to repay any of Lou's shareholder advances. Another widget manufacturer is unable to utilize Lossco's losses because its operations have now been discontinued. Is there any value to Lou's shares? The answer is no, but there may be value to Lou's $1 million uncollectible loan.

It is critical that Lossco carried on an active business in Canada (as opposed to, say, an investment business), thus meeting the definition of a qualified small business corporation ("QSBC"). The insolvency of Lossco in 1995 signals the uncollectibility of its debt to Lou. As a result, Lou may recognize a capital loss on this loan in 1995. The capital loss may only be applied against capital gains, and if Lou has none, this loss would otherwise have no current value to him. However, if Lossco was a QSBC, a capital loss arising from a loan thereto is known as an allowable business investment loss ("ABIL"), of which 75% of the loss is deductible against *any* other income including that from employment, investment, and any business. As a result, Lou has a $750,000 loss available to be carried back up to three years or forward up to seven years. If unused after seven years, the remaining portion converts to a capital loss. If Lou pays tax personally at 50%, the value of the loss can be as high as $375,000 depending on a number of factors, including present value adjustments.

All of these things should be kept in mind, as it is very easy to conclude that the shares of a corporation with no assets and a history of losses cannot possibly have any value. As can be seen, this is not always the case.