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Acquiring a U.S. Corporation: A Primer

As a result of the economic downturn, Canadian companies may see buying opportunities with respect to distressed businesses south of the border in the U.S. The following are four issues to consider with respect to acquiring a U.S. business.

Acquiring a Loss Corporation

Whereas Canada has rules which allows for the assumption of net operating losses when acquiring a company in the “same or similar” business, the U.S. has no such rules.

There is a provision under U.S. rules which severely inhibits the ability to traffic in U.S. NOLs regardless of whether the acquiring company in a similar business. Under this provision, if there is a 50 percentage point movement in the ownership of a company within an approximate three year period, the amount of pre-acquisition NOL which becomes unrestricted on an annual basis is equal to the value of said U.S. corporation multiplied by a tax-exempt rate published by the IRS on a monthly basis.

Deemed Year-End

In general, acquiring a U.S. corporation does not trigger an automatic deemed year-end unless the target company is leaving or entering a U.S. federal consolidated group on the acquisition date or if the acquired corporation is an S corporation. In fact, if the acquiring corporation has a different year-end than the U.S. target, appropriate steps should be considered to qualify for an automatic year-end change if a synchronization of year-ends is desired.

Deemed Asset Sales

In situations where the inside basis of a target's assets are lower than the fair market value of the target, there is a natural tension between the buyer and seller with respect to the basic structure of the transaction.

In general, the buyer is interested in acquiring assets in order to obtain a prospective tax benefit from the enhanced tax bases (i.e. most acquired intangible assets are amortizable over 15 years). On the other hand, the seller does not want to pay tax within the corporation and again on the disposition of or distribution of the after-tax proceeds of the asset sales. As well, the seller may want to rid itself of any prospective contingent liabilities in the corporation.

If the target corporation is either a U.S. S corporation (i.e. a flow-through type corporation similar to a partnership which most closely-held U.S. corporations are) or a member of a U.S. federal consolidated, a deemed asset election under IRC Section 338(h)(10) can avail both parties to the transaction to the best of both worlds.

Under the election, the sale of the corporation is treated as such from a legal perspective. However, the underlying assets receive a basis bump for U.S. tax purposes.

Certain factors such as depreciation recapture, inconsistent state tax rules and/or the transfer of less than 100% interest (i.e. there must be a minimum of an 80% ownership transfer on purchase) in the target can often cause a seller to incur a higher tax liability from the deemed asset sale election than he or she would have been subject to on the sale of the stock absent the deemed asset sale election.. A "gross up" provision may be included in the Share Purchase Agreement. As the election is more than 8.5 months after the sale, advisors to the purchaser would have to evaluate whether the cost of the gross-up provision outweighs the benefit of the election.

Due Diligence

When acquiring any U.S. corporation, due diligence should focus on potential contingent liabilities of the target. For example, if the target made a late "s" corporation election, significant tax liabilities could be incurred by the buyer to the extent that the target had a built-in-gain on the effective date of the Selection.

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