Income Tax and Expropriation Compensation

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Taxation of Expropriation Compensation

Taxation of Expropriation Proceeds

Replacement & Deferrals

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Taxation of Expropriation Proceeds

"Expropriation" is disposition

☞ For Income Tax purposes, where a Claimant has received compensation for property taken they are deemed to have disposed of the property.

How is the Expropriation Compensation Taxed?

☞ Tax treatment depends on the nature of the compensation.

☞ If compensation is for the market value of assets taken, resulting gains or losses will be determined and taxed as if the property had been sold. Taxation will then depend on the type of property taken.

☞ If compensation is for disturbance damages, resulting income will generally be taxed as business income.

Taxation of Expropriation Proceeds

How are Specific Types of Compensation Taxed?

☞ Gains on the disposition of real property held as capital (investment and personal properties) are taxed as a capital gains/losses and recaptures/terminal losses.

☞ Real property held as inventory is taxed as business income.

☞ Compensation paid to a tenant is considered to be on account of a leasehold interest.

☞ Ordinary interest paid on the amount of compensation is taxed as interest income.

☞ Taxation of compensation for loss of business income is normally taxed as active business income.

☞ Compensation for goodwill is taxed on a basis similar to that of capital properties (i.e., 75% of gain).

Taxation of Expropriation Proceeds

How are Specific Types of Compensation Taxed?

☞ Reimbursement of costs of relocation, including moving and legal costs to acquire new premises are part of proceeds of disposition of the former premises.

☞ Legal, appraisal and other costs incurred in determining compensation to the Claimant must be allocated on a reasonable basis to the various properties disposed of and taxed accordingly. Any recoveries are netted against the related costs.

☞ Where the Board does not specifically identify the compensation for specific assets, the Claimant must allocate compensation on a reasonable basis.

Taxation of Expropriation Proceeds

When are disposition proceeds taxable?

☞ Generally, the earliest of:

- The day the Claimant has agreed to an amount as full compensation;
- The day the Claimant's compensation has been determined by the Board; and
- The day that is two years following the day the property is taken by expropriation.

☞ The acceptance of an advance payment generally need not be taken into account for income tax purposes until the full amount of the compensation has been determined.

Replacement & Deferrals

What are the Replacement Property Rules?

☞ The Replacement Property Rules are provisions of the Income Tax Act that provide a taxpayer relief from some of the adverse tax consequences of expropriation.

☞ The Replacement Property Rules:

- allow a Claimant to defer capital gains and recapture on expropriated property
- allow a Claimant to defer the gain on the disposition of goodwill.

Replacement & Deferrals

What is Needed to Qualify for Replacement Property treatment?

☞ For the Replacement Property Rules to apply, the following criteria must be met:

- The replacement property must be put to the same use as the former property;
- The replacement property must be in Canada;
- Where the property was used to earn income from a business, the replacement property must be put to use in a similar business; and
- The replacement property must be acquired before the end of the second taxation year after the date of disposition (see above).

Replacement & Deferrals

What income can a claimant defer?

☞ With respect to property, a Claimant can defer the recapture and capital gains to the extent that he acquires replacement property of a value equal to or greater that the gain on the former property.

☞ If a Claimant buys "more land and less building", reallocation provisions permit the Claimant to reallocate the proceeds of disposition so as to defer the gain.

☞ The deferred gain reduces the income tax cost of the replacement property - i.e., the gain is only deferred until the replacement property is sold.

Can Gains from Proceeds on Goodwill be Deferred?

☞ Gain on goodwill can be deferred to the extent a new business is acquired.

☞ Goodwill from a business can be deferred as well, but must be used in the same or similar business.

☞ Goodwill related to a rental business does not qualify.

Tax Issues in the Determination of Expropriation Compensation

Income Taxes & Determination of Compensation

Adverse Tax Consequences of Expropriation

Income Tax Gross-Ups

Actton/Super-Save Decision

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Income Taxes & Determination of Compensation

Disturbance Damages

☞ Theoretically, the Claimant should be restored to same financial position had there been no disturbance.

☞ Generally income taxes are ignored in the calculation of disturbance damages - i.e., all calculations are done on a pretax basis.

☞ By calculating damages on a pretax basis, a claimant is normally put back into the same position as if they had earned the income.

☞ Example: if Claimant's loss of earnings is assumed to be $150,000 per year for two years:

After-Tax Earnings If No Disturbance

Pre-tax loss (2 x $150,000)	$300,000
Taxes @ 22%	(66,000)
Net After-Tax	$234,000

Income Taxes & Determination of Compensation

Disturbance Damages

Compensation if Awarded on an Pretax Basis

Compensation	$300,000
Tax on award @ 22%	(66,000)
Net After-Tax	$234,000

☞ If compensation award on an after-tax basis, "double taxation" would occur -

☞ Example: if loss of earnings assumed to be $150,000 per year during a two year period, which is $234,000 after tax (see above):

Compensation if Awarded on an After-tax Basis

Compensation	$234,000
Tax on award @ 22%	(51,000)
Net After-Tax	$183,000

☞ The Claimant would be worse off by $51,000 as a result of expropriation, if compensation was calculated on an after-tax basis.

Income Taxes & Determination of Compensation

Property

☞ The fair market value or market value of an asset or property is calculated on the assumption that it has all of the tax attributes of a similar asset, purchased in the market.

☞ In determining values, it is appropriate to assume that the asset or property has a "full income tax cost base". This make sense, as

> *"Fair market value is defined as the highest price available in an open and unrestricted market between informed prudent parties, acting at arm's-length and under no compulsion to act, expressed in terms of cash"*

and as the Expropriation Act defines market value as

> *"The market value of an estate or interest in land is the amount that would be paid for it had it been sold at the date of the expropriation in the open market by a willing seller to a willing buyer". (Part 6, Section 32)*

Buyers determine market values, not the sellers

Income Taxes & Determination of Compensation

Property

☞ Generally, real estate, equipment, inventory, leasehold improvement, and other types of property or asset appraisals are based on an approach which ignores income taxes.

Goodwill

☞ In theory, commercial goodwill represents the discounted value of a future business income stream. In theory, the best method of calculation would be a discounting of after tax cash flow.

☞ In practice, the fair market value of a business or goodwill can be determined using a number of different approaches, some based on using pretax earnings and others based on after-tax earnings.

☞ Theoretically each approach should arrive at the same value - i.e."pretax goodwill" and "after-tax goodwill" are not meaningful terms..

Adverse Tax Consequences of Expropriation

Not Willing Sellers

☞ The market value and fair market value definitions implicitly assume a willing seller. <u>A claimant is not, in reality a willing seller.</u>

Early or Extra Tax

☞ Expropriation is a forced disposition, which can result in an acceleration or early payment of income taxes.

☞ Claimants may pay income taxes that, but for the expropriation, would never have been paid.

☞ Claimants - both individuals and corporations - may be subject to higher marginal income tax rates as a result of “lump-sum” compensation awards, all being taxed in a single year.

Adverse Tax Consequences of Expropriation

No Planning

☞ Normally taxpayers attempt to plan their affairs and structure their businesses so as defer and avoid tax. Expropriation dictates the method of disposition and eliminates most planning and avoidance opportunities.

☞ Except for the limited deferral and rollover provisions, no relief is given to claimants.

☞ As compensation is for the disposition of assets, shareholders lose tax benefit of capital gains exemption on sale of shares.

Income Tax Gross-Ups

Compensation for Adverse Tax Consequences

☞ Claimants often calculate and claim compensation for financial losses arising from the adverse income tax consequences of expropriation.

☞ Claims for compensation for the income tax consequences of the receipt of compensation and claims for income benefits lost as a result of expropriation are invariably denied (Eric Todd - The Law of Expropriation and Compensation in Canada)

☞ Why "invariably denied"?

- A willing seller is assumed.
- It is a "Value to Owner" issue.
- Seller or Claimant's tax position is irrelevant to the determination of fair market value.

Expropriation Compensation isn't Necessarily Fair
(but neither is income tax)

Actton/Super Save Decision

Background

☞ The Actton/Super-Save Decision awarded compensation for the loss of commercial goodwill.

☞ Any award based, even in part, on consideration of the Claimant's tax consequences could be interpreted as a tax gross-up.

☞ The essential issue to be discussed and considered by the Board was, *"whether to increase the value of goodwill in recognition of the income tax benefits available to a purchaser from the amortization of goodwill"*.

☞ Summary of the Board's decision relating to calculation of goodwill:

- The market value of the Station's goodwill was initially determined by capitalizing *after-tax cash flows* using a capitalization rate of 20%, resulting in an initial goodwill value of $43,843.
- The Claimant's expert, calculated an additional amount for the *"income tax benefit of the amortization of the purchaser's cost for goodwill"*.

Actton/Super Save Decision

Background

- The Board allowed 50% of this tax benefit, concluding on page 38, *"that the tax implications to the parties in the notional sale of Station No. 23 are, at best, uncertain and that something between zero and 100% of the indicated tax shield would be negotiated".*

- The Board calculated 100% of the goodwill tax shield (benefit) as:

  Tax Benefit = (Capitalized value x 75% x income tax rate x amortization rate)/(rate of return + amortization rate)

- Goodwill award = Capitalized value of cash flow ***plus*** 50% of the tax benefit

Actton/Super Save Decision

Our View

☞ Our view is that the only significant error in the board's decision, assuming that they accepted capitalization of cash flow as the appropriate valuation approach, was to discount the "tax shield" by 50%.

☞ Buyers determine the value of assets - including goodwill - and it is assumed that the asset purchased has a full income tax cost base, which in this case means they would get 100% of the tax shield.

☞ If value is based on a notional calculation, such as discounting of cash flow, capitalization of cash flow, or capitalization of earnings, there is no "bargaining" between buyer and seller.

☞ The buyer is simply calculating the financial benefits consequence to ownership, one of which is the ". . . *income tax benefits available to a purchaser from the amortization of goodwill*".

Actton/Super-Save doesn't open the Door for Tax Gross-Ups
(or at least it shouldn't)

Actton/Super Save Decision

(some further detail)

Issues

☞ To understand the income tax issue, it is important to look at the fair market value definition. In particular, it is important to recognize that fair market value is the *"highest price in the market"*, not the value to the owner of the asset. In the context of valuation of a capital asset, this means that :

- the general tax characteristics of the class of asset being valued are relevant to the valuation - as they impact on the future cash flows which a notional or real purchaser will derive from the asset; however

- the particular income tax attributes which are unique to the owner, such as the asset's adjusted cost base, undepreciated capital cost, etc., and which are not transferred in a notional market transaction, are irrelevant - as they have no impact on the future cash flows which a notional or real purchaser will derive from the asset.

☞ The real issue is the proper application of the capitalized cash flow valuation method.

Actton/Super Save Decision

(some further detail)

Capitalization of Earnings Approach

☞ The Board determined that:

- no market comparable exists, and that the value of goodwill should be based on a notional value; and
- the value of goodwill should be based on an analysis and capitalization of after-tax cash flow.

☞ In this case, the fair market value of goodwill is, theoretically, the discounted value of expected future after-tax cash flows. As such, the Discounted Cash Flow method ("DCF") is, in theory, the most sound valuation approach.

☞ Capitalized cash flow is a short-form DCF. For the capitalized cash flow approach to result in the same value as DCF, certain adjustments are necessary.

☞ An adjustment is required to recognize tax benefits. In this case, of amortizing goodwill for income tax purposes.

Actton/Super Save Decision

(some further detail)

Capitalization of Earnings Approach

☞ The "capitalization of tax flow " valuation approach is based on the following:

- Constant maintainable cash flow
- The capitalization rate used will be the appropriate discount rate , reduced by a factor to reflect growth.

  Capitalization Rate = (1 + growth)/(Discount rate - growth)

☞ It is necessary to recognize 100% of the goodwill tax shield because taxes as calculated in arriving at maintainable cash flow did not recognize the tax benefit (or reduced taxes) of amortizing purchased goodwill for tax purposes.

☞ The tax shield is not a tax gross-up. The "tax shield add-on" is just a simplification to the discounted cash flow valuation approach. It does not consider, or compensate for early or adverse taxation of the claimant; it reflects a component of the intrinsic value of goodwill as a capital asset.

Actton/Super Save Decision

(some further detail)

Capitalization of Earnings Approach

☞ Taxes in the hands of the seller are irrelevant in determining fair market value; this is a value to owner consideration

Conclusion

☞ The Board is in effect saying that the buyer should recognize 100% of the fair market value of one part of the prospective cash flow stream and only 50% of the fair market value of another part. This is contrary to the capitalized cash flow approach. In the notional market, we are assuming a group of informed buyers who will bid the price of an asset up to its fair market value. Notional value is calculated based on capitalized cash flow. An informed, prudent buyer would pay full value; if this wasn't the case, no one would ever get paid fair market value.

Actton/Super Save Decision

(some further detail)

Conclusion

☞ Formula used by the Board was:

G = (CF/20%) + ((CF/20%) x 43% x 75% x 7%)/(7% + 20%))

Where G = goodwill; and CF = maintainable after-tax cash flow, a 20% discount rate is applied and the income tax rate is 43% .

☞ The formula used by the Board to calculate the tax shield, and goodwill, though close, is not correct.

☞ The appropriate formula is complicated, and requires an iterative calculation, because the amount of goodwill depends on the amount of tax shield and the tax shield in turn depends on the amount of calculated goodwill.

☞ The formula that should have been used is as follows:

G = (CF/20%) + ((G x 43% x 75% x 7%)/(7% + 20%))

Where G = goodwill; and CF = maintainable after-tax cash flow, a 20% discount rate is applied and the income tax rate is 43% .