



The Navigator



Wealth
Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Investment holding companies

Tax implications of investing through a corporation

On July 18, 2017 the federal government released a consultation paper proposing a number of strategies which target private corporations with regards to income splitting, multiplication of the lifetime capital gains exemption, holding a passive investment portfolio inside a private corporation, and converting a private corporation's regular income to capital gains.

Generally, effective for 2018 and later taxation years, the government has proposed to limit income sprinkling to family members receiving "reasonable" compensation from a private corporation. The proposed measures extend the tax on split income rules (often known as "kiddie tax") to adults and limit the multiplication of claims to the lifetime capital gains exemption.

The government is also seeking input on possible measures to eliminate the tax advantage of investing undistributed earnings from an active business in a private corporation. If enacted, these measures may result in a disincentive for investing passively within a corporation.

The strategies discussed in this article may be affected by the proposed measures in the consultation paper and the accompanying proposed legislation. If you are an owner of a private corporation you should consider the potential impact of the proposed measures and discuss the implications with your qualified tax advisor.

Please contact us for more information about the topics discussed in this article.

Earning investment income through a corporation can be complex as you have to consider the taxes payable in the corporation as well as the taxes payable on withdrawing the funds from the corporation. This article outlines the major advantages and disadvantages of using an investment holding company for investments, and identifies situations where the use of an investment holding company may be beneficial.

This article outlines several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax advisor before acting on any of the information in this article.



One of the purposes of an estate freeze is to “freeze” a company’s share value for the original shareholders and pass on the future growth of the corporation to the next generation or to other desired individuals.

Investing through a holding company

An investment holding company is not a defined term in the Income Tax Act. It is a term used to describe a corporation that holds passive assets, such as shares of another company. Typically, you would not be running an active business inside a holding company.

The Canadian tax system is designed to be neutral between investment income earned personally and investment income earned through a corporation. What this means is that after the corporation pays tax on its investment income and the shareholder pays personal tax on dividends received from the corporation, the total corporate and personal tax payable should be approximately the same amount as what the shareholder would have paid if the investment income was earned directly by the shareholder. Accordingly, there should be no material tax deferral opportunity and/or taxes payable on passive income earned in a corporation. This is the concept of integration, which of course does not always work perfectly. In fact, in almost all provinces, the integrated tax rate for investment income earned through a corporation is slightly higher than the personal tax rate for investment income. So why would anyone consider having a holding company?

Advantages of using an investment holding company

The following are some of the major advantages of having an investment holding company.

Estate freezes

An investment holding company can be used to implement an estate freeze. One of the purposes of an estate freeze is to “freeze” a company’s share value for the original shareholders and pass on the future growth of the corporation to the

next generation or to other desired individuals. This way, the capital gains triggered on the deemed disposition of the shares upon death and probate taxes for the original owner of the company may be minimized. Where an estate freeze is done to benefit a spouse and/or minor children, the corporate attribution and “kiddie” tax rules discussed in the next section should be considered.

Another use of an estate freeze is to crystallize the capital gains exemption on the transfer of qualifying small business corporation shares. You may want to do so if currently, your shares qualify for the capital gains exemption and you expect that they will not qualify for the exemption in the future. It should be noted that holding companies that are used only to hold an investment portfolio do not qualify for the capital gains exemption.

As estate freezes are quite complex transactions, they should only be undertaken with the assistance of a qualified tax advisor.

Income splitting

Certain income tax rules are designed to discourage income splitting with spouses and related minor children through the use of an investment holding company. One such rule is corporate attribution. Corporate attribution generally applies when an individual transfers or lends property to an investment holding company and one of the main purposes of the transfer or loan is to benefit a spouse or a related minor child (which includes a grandchild, niece or nephew) who owns 10% or more of any class of shares in the investment holding company. If corporate attribution applies, then the individual who transferred or lent the property to the corporation is deemed to have received interest income in the year equal to the CRA prescribed rate of interest for the



Holding U.S. investments in a Canadian corporation may minimize or eliminate the Canadian shareholder's exposure to U.S. estate tax.

period on the outstanding amount of the transferred property or loan. This annual deemed interest benefit is reduced by the following:

- Any actual interest received in the year by the individual in respect of the transfer or loan;
- Grossed-up taxable dividends received by the individual in the year on shares that were received from the corporation as consideration for the transfer; and
- Income subject to kiddie tax (discussed below) reported by the related minor child.

Another rule that restricts the ability to split income with minor children is known as the split income rule (also known as kiddie tax). Under this rule, a minor child who receives certain dividend payments from a Canadian corporation whose stock is not listed on a designated stock exchange (e.g. a privately held company) is taxed on the grossed-up value of the dividend received at the highest personal marginal tax rate. The parent is also jointly and severally liable with the child for the taxes payable on the split income.

Both the corporate attribution and split income rules do not apply where the shareholders of the holding company are adult children. Therefore, it is possible to split income with adult children through the use of an investment holding company without triggering the above mentioned adverse tax consequences. You may incorporate a holding company and the adult children can subscribe for the shares of the company. It may also be possible to transfer certain assets to the holding company on a tax-deferred basis to benefit your adult children. Income earned in the corporation can be paid as dividends to the adult children and taxed in their hands.

There are also more sophisticated ways of structuring a holding company that avoid the application of the corporate attribution rules with respect to a spouse or minor children. However, these structures are beyond the scope of this article. In any case, as this area of taxation is quite complex, it is strongly recommended that you discuss these issues with a qualified tax advisor prior to implementing any strategies.

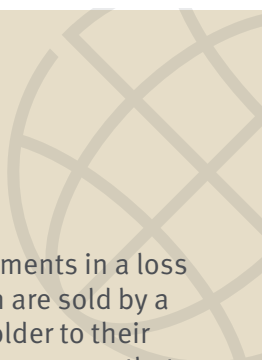
Inter-corporate tax-free dividends

A common corporate structure involves a holding company owning shares of an operating company. Incorporating a holding company into an existing corporate structure may be advantageous if you want to move assets or funds out of the operating company but do not necessarily want to pay personal tax on the assets or funds.

In certain circumstances, it may be possible to move these assets or funds from the operating company to the holding company as an inter-corporate tax free dividend. Speak to your qualified tax advisor for more information about the tax implications of moving assets between an operating and holding company.

Creditor protection

If you have excess earnings in your operating company each year, you may want to move the excess funds to a holding company. This may protect those earnings from creditors of your operating company. If the operating company needs working capital, your holding company can lend that money back to your operating company on a secured basis to maintain the potential protection from creditors. It is essential that you speak with a qualified legal advisor regarding any asset protection options available to you. You may also wish to speak to a qualified tax advisor about the tax implications of moving the funds from your holding company to your operating company.



If investments in a loss position are sold by a shareholder to their holding company that is controlled by them or their spouse, and the holding company holds these investments for at least 30 days, any capital losses arising from the transaction cannot be claimed by the shareholder on their personal income tax return.

U.S. estate taxes

Holding U.S. investments in a Canadian corporation may minimize or eliminate the Canadian shareholder's exposure to U.S. estate tax. For more information on this topic, speak with your qualified tax advisor.

Probate taxes

In certain provinces, you may be able to reduce your exposure to probate taxes on death by using a multiple Wills strategy. You may have a "Primary" Will dealing with assets that require probate to transfer ownership, such as a bank account or investment portfolio. A "Secondary" Will may be used to transfer assets that do not require probate such as artwork or private company shares. Under provincial corporate statutes, it may be possible to transfer share ownership on death without probate. Using an investment holding company in conjunction with a secondary Will may therefore minimize probate taxes on death. Note that the probate taxes may not be significant enough to justify establishing an investment holding company. The avoidance of probate taxes should be viewed as a secondary benefit of using an investment holding company.

There may also be circumstances where the secondary Will needs to be probated. For example, if your Will contemplates that the shares or the assets of the company be transferred to a trust set up in your Will, probate may be required by a financial institution to open the investment account for the trust. Furthermore, some financial institutions may require that the secondary Will be probated as a matter of policy.

More information on probate taxes is available from your qualified tax/legal advisor.

Control of amount and timing of income

Some federal non-refundable tax

credits and benefits, such as the age amount (a non-refundable tax credit) and Old Age Security (OAS) benefits are reduced or eliminated when your net income exceeds certain thresholds. If investment income is earned and retained in an investment holding company, you may be able to manage your personal income to keep it below those thresholds. Keep in mind however that keeping investment income in an investment holding company may effectively result in a prepayment of taxes. The prepayment of taxes works as a deterrent to those who attempt to defer income tax on investment income by using a corporation. A portion of the prepaid taxes is refundable only upon payment of taxable dividends to the shareholder. To reduce the amount of prepaid taxes, you may consider investing in tax-efficient investments (e.g. securities that offer deferred capital growth).

Also, as previously discussed, the combined corporate and shareholder taxes paid on investment income earned through an investment holding company may be slightly greater than personal income taxes paid on such income.

Disadvantages of using an investment holding company

While there are a number of advantages to having an investment holding company, there are also disadvantages. You should consider the following disadvantages if you are planning to set up or currently have a holding company.

Capital losses and the superficial/stop-loss rules

If investments in a loss position are sold by a shareholder to their holding company that is controlled by them or their spouse, and the holding company holds these investments for at least 30 days, any capital losses arising from the transaction cannot be claimed by the shareholder on their personal income tax return.



Losses that arise in a corporation can only offset earnings in that corporation.

The shareholder's capital loss will be denied, and the cost base of the transferred property, now owned by the holding company, will be increased by the amount of the denied capital loss. This means that the cost base of the shareholder's investment rolls over to become the cost base of the investment now held within the holding company. When the holding company subsequently sells the investment to a third party, if the investment is still in a loss position, the capital loss may then be recognized by the holding company.

On the other hand, if a holding company disposes of a security at a loss, and that same security is acquired by a controlling shareholder or anyone affiliated with them (i.e. your spouse, a company controlled by you and/or your spouse, or a trust in which you and/or your spouse are a majority interest beneficiary) at any time within 30 days before or after the disposition by the holding company, then the holding company will be unable to recognize the loss until the controlling shareholder or the affiliated person disposes of the security to a third party. The ability to claim the loss at a point in the future stays with the investment holding company. The loss cannot be claimed by the controlling shareholder or the affiliated person in this situation.

Losses trapped

Losses that arise in a corporation can only offset earnings in that corporation. Losses incurred in a corporation cannot be transferred to its shareholders. Alternatively, if you own investments personally, you can utilize the losses, depending on their nature to reduce your taxable income in the current year or carry them to the future years.

Capital gains exemption

You may qualify for the capital gains exemption if you dispose of shares of a small business corporation if

certain conditions are met. One of the conditions is that the small business corporation is a Canadian-controlled private corporation. It must use all or substantially all of the fair market value of its assets in an active business carried on primarily in Canada. Since an investment holding company derives most of its income from passive investments, it generally does not qualify as a small business corporation and the capital gains exemption is not available when its shares are sold.

There are circumstances where you may qualify for the capital gains exemption when you sell an investment holding company such as where all or substantially all of the investment holding company's holdings are in an underlying Canadian small business corporation. If this is the case, the sale of investment holding company shares may qualify for the capital gains exemption if it satisfies the other conditions. However, a purchaser may not be interested in purchasing the shares of a holding company because they will acquire not only the assets of the corporation but also its liabilities. Therefore, it may be necessary to reorganize the holding company and the target operating company in order to access the capital gains exemption. The reorganization process is beyond the scope of this article and you may want to discuss this matter with your qualified tax advisor.

Incorporation and compliance costs

Incorporation and other legal fees may be incurred when establishing an investment holding company. In addition, there are on-going costs and administrative requirements associated with corporate ownership. For example, you will need to ensure company minutes are kept up to date. Shareholder agreements may be required and annual financial statements and tax returns must be prepared and filed on a timely basis.



Individuals owning shares in holding companies at death may be subject to double taxation.

Estate Planning

When engaging in any estate planning, you should consider how your interest in your investment holding company and the company's assets will be dealt with on your death. You should also consider what steps your executor may need to take to transfer your shares or corporate assets to your beneficiaries.

Corporations do not cease to exist on the death of a shareholder. A corporation is its own legal entity, separate from its owners. On your death, your investment holding company will remain in existence and may continue to operate as a holding company. If you are the sole officer and director of your company, you may want to consider appointing additional officers and directors prior to your death. These individuals can continue to provide direction with respect to your corporate assets after your death. Otherwise, your executor may need to take certain steps and incur fees in order to deal with your investment holding company after death.

On your death, the shares of your investment holding company will form part of your estate and be distributed in accordance with your Will, or if you have no Will, the governing provincial/territorial intestacy laws. When drafting your Will, you should consider whether you want the shares to pass outright to your named beneficiaries or the company to be wound up. You may also want to consider the tax implications of these different options (discussed in more detail below) to your estate and beneficiaries. To ensure you have properly addressed all estate planning issues with respect to your investment holding company, speak with your qualified legal and tax advisor.

Taxes at death

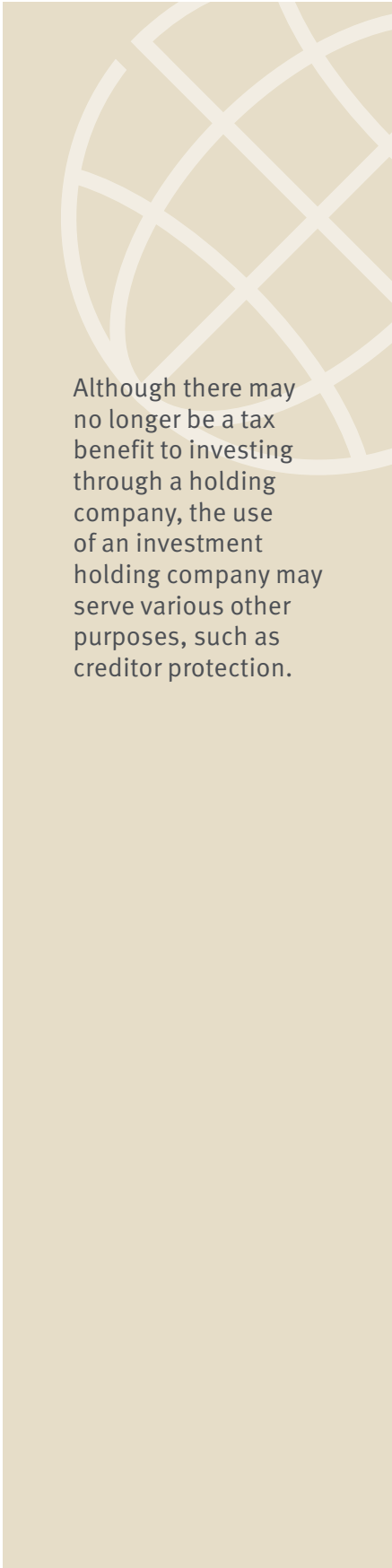
Individuals owning shares in holding companies at death may be subject to double taxation. First, the deceased

is taxed on the gain arising from the deemed disposition of the shares of the holding company at death. The amount of the capital gain is based on the fair market value of the shares of the holding company, which in turn derive their value from the fair market value of the investments and assets in the holding company. Then, when the holding company is wound up and distributes its assets to its shareholder (i.e., the deceased's estate), a second level of tax is triggered. Alternatively, a redemption of the shares by the estate or the beneficiaries may result in a taxable dividend. Therefore, the value of the investment in the holding company may be taxed twice, once as a capital gain to the deceased and the second as a dividend to the estate/beneficiaries.

It is possible to defer this potential double tax by transferring the shares of the holding company to a surviving spouse or qualifying spousal trust on a tax-deferred basis. There are also other post-mortem planning alternatives that may eliminate this double taxation. For example, in general, when a corporation is wound up by the shareholder's estate, it will result in a deemed dividend and capital loss to the estate. If the corporation is wound up in the first taxation year of the estate, the estate may be able to carry back the capital loss realized to the deceased shareholder's final taxation year and offset the capital gain realized on the shares. The double tax issue may be eliminated with the loss carry back because the net result is that the estate only pays dividends tax. For more information on strategies that may mitigate this double tax exposure, talk to your qualified tax advisor.

Transactions between you and your holding company

Certain tax rules govern transactions between a shareholder and their company. These rules are designed to prevent the tax-free distribution of the accumulated surplus of the



Although there may no longer be a tax benefit to investing through a holding company, the use of an investment holding company may serve various other purposes, such as creditor protection.

company to the shareholder while the company continues to operate. One of these rules relates to shareholder benefits. Shareholder benefits are construed very broadly to include any benefits or advantages conferred on a shareholder by the holding company and, subject to some exceptions, include any transfer of corporate assets to the shareholder for less than fair market value consideration in return. The amount of the benefit must be reported by the shareholder as income in the year that the benefit is received. For example, if the holding company transfers a security with a fair market value of \$100 to a shareholder in exchange for \$50 cash, the holding company is deemed to have disposed of the security for \$100, and the shareholder may be required to include the \$50 difference as income on their personal tax return. If the security is of capital nature to the shareholder, the amount of the benefit is added to the adjusted cost base of the security.

Another rule that is directed at preventing shareholder appropriation of corporate assets relates to shareholder loans. It would be possible, if not for this rule, for a shareholder to escape tax on the distribution of corporate surplus by simply borrowing the funds of the holding company with the shareholder never repaying the funds. Subject to certain exceptions, this rule requires that, the shareholder or

a person who is connected with the shareholder include in income the principal amount of all loans received from the holding company during the year. Subsequent repayment of the loan will generate a tax deduction in the year that the repayment is made, unless the repayment is considered as part of a series of loans and repayments. The income inclusion rule would not apply if the entire loan is repaid within one year after the end of the taxation year of the corporation.

Conclusion

Although there may no longer be a tax benefit to investing through a holding company, the use of an investment holding company may serve various other purposes, such as creditor protection. Consider the advantages and disadvantages if you are thinking of setting up an investment holding company.

If you have an existing holding company, there may be other reasons why you should keep it open. You may not wish to wind up your company where the dissolution may result in the realization of previous tax deferrals and existing unrealized capital gains.

You should consult with a qualified tax advisor to determine if you can benefit from an investment holding company or whether an existing holding company should be wound up.

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