Investment Holding Companies

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1 › Introduction

Years ago, the use of a Canadian Investment Holding Company was considered an attractive tax planning technique. In the past, the use of a Canadian Investment Holding Company allowed for both the deferral of taxes and the payment of less total tax compared to holding investments personally in a non-registered account. However, tax changes at the federal and provincial levels over the past several years have more than eliminated any of these advantages. This publication outlines the major advantages and disadvantages of using an investment holding company for investments and it identifies the situations where the use of an investment holding company may still be beneficial.

The idea of investing through an investment holding company (a corporation established or continued for the sole purpose of earning passive investment income) is intriguing to many investors. It is often believed that the use of such a vehicle can result in tax savings, either in the form of a tax deferral and/or less total taxes paid. In the past this was true. The combined corporate/shareholder tax rates on interest, foreign income, rent, royalty, and taxable capital gains income ("investment income") were, in many cases, lower than personal marginal tax rates on such income. It was therefore possible to save taxes by investing through an investment holding company. Furthermore, since corporate investment tax rates were lower than personal tax rates, a tax deferral opportunity was also available by investing and retaining income in the investment holding company.

As a result of changes to the Canadian tax system over the last several years, the tax advantages associated with investment holding companies have all but been eliminated. It is no longer possible to defer taxes through an investment holding company and the combined corporate/shareholder tax rates on investment income in every province now exceed the top marginal personal tax rates paid on the same income.

2 › Corporate taxation of investment income

A high corporate tax rate is initially imposed by the Canadian tax authorities on income earned by an investment holding company to prevent the use of an investment holding company to defer tax. There are no progressive tax rates and no tax brackets in an investment holding company like there are for personal taxes. There is simply one high tax rate applied to all income earned in an investment holding company. A portion of the taxes paid is refundable when the holding company pays a taxable dividend distribution to its shareholders. An investment holding company should therefore consider distributing its income to its shareholders in the same fiscal year that it is earned to minimize the net amount of corporate taxes paid for the year. **Table 1** shows the combined federal/provincial corporate tax rate on interest, rent, royalties and the taxable portion of capital gains earned and retained in the investment holding company. Depending on the province, this rate can range anywhere from 47.3% (Alberta) to 52.8% (Saskatchewan) for year 2005. Larger holding companies may also be subject to Capital Tax. This additional tax is discussed later on page 9.

By comparison, the highest personal marginal tax rate on such income ranges from 39.0% (Alberta) to 48.6% (Newfoundland & Labrador) as shown in **Table 2**.

As these tables suggest, a higher rate of tax is applied against interest, foreign income, rent, royalty, and taxable capital gains income when such income is earned through an investment holding company than if such income were earned personally. Depending on the province, this difference can range anywhere from 1.2% (Newfoundland & Labrador) to 8.3% (Alberta).

When the investment holding company makes taxable dividend distributions, a portion of the taxes paid is refunded to the investment holding company, thereby reducing the overall corporate taxes paid on investment income. The net effective corporate tax rate on investment income for each province is shown in **Table 3**.

Table 1 — Combined Federal/Provincial Corporate Tax Rates on Investment Income retained in the Holding Company — year 2005 (as of May 31, 2005)

INVESTMENT	INTEREST, RENT, FOREIGN INCOME, ROYALTIES	CAPITAL GAINS	CANADIAN DIVIDEND
BC	49.3%	24.7%	33.3%
ALTA	47.3%	23.7%	33.3%
SASK	52.8%	26.4%	33.3%
MAN	50.8%	25.4%	33.3%
ONT	49.8%	24.9%	33.3%
QUE	52.0%	26.0%	33.3%
NB	48.8%	24.4%	33.3%
NS	51.8%	25.9%	33.3%
PEI	51.8%	25.9%	33.3%
NFLD & LAB	49.8%	24.9%	33.3%
YUKON	50.8%	25.4%	33.3%
NWT	49.8%	24.9%	33.3%
NUNAVUT	47.8%	23.9%	33.3%

Table 2 — Top personal marginal rate on investment income — year 2005 (as of May 31, 2005)

INVESTMENT	INTEREST, RENT, FOREIGN INCOME, ROYALTIES	CAPITAL GAINS	CANADIAN DIVIDEND
BC	43.7%	21.9%	31.6%
ALTA	39.0%	19.5%	24.1%
SASK	44.0%	22.0%	28.3%
MAN	46.4%	23.2%	35.1%
ONT	46.4%	23.2%	31.3%
QUE	48.2%	24.1%	32.8%
NB	46.8%	23.4%	37.3%
NS	48.3%	24.1%	33.1%
PEI	47.4%	23.7%	32.0%
NFLD & LAB	48.6%	24.3%	37.3%
YUKON	42.4%	21.2%	28.6%
NWT	43.1%	21.6%	29.6%
NUNAVUT	40.5%	20.3%	29.0%

Table 3 — Net corporate tax rate on investment income earned in the holding company and paid to shareholder in the same year — year 2005* (as of May 31, 2005)

INVESTMENT	INTEREST, RENT, FOREIGN INCOME, ROYALTIES	CAPITAL GAINS	CANADIAN DIVIDEND
BC	24.0%	12.0%	0.0%
ALTA	21.0%	10.5%	0.0%
SASK	29.2%	14.6%	0.0%
MAN	26.2%	13.1%	0.0%
ONT	24.7%	12.4%	0.0%
QUE	28.0%	14.0%	0.0%
NB	23.2%	11.6%	0.0%
NS	27.7%	13.9%	0.0%
PEI	27.7%	13.9%	0.0%
NFLD & LAB	24.7%	12.4%	0.0%
YUKON	26.2%	13.1%	0.0%
NWT	24.7%	12.4%	0.0%
NUNAVUT	21.7%	10.9%	0.0%

*Adjusted for inability to obtain a full refund of the Refundable Dividend Tax On Hand (RDTOH) account.

Canadian source dividend income received by a holding company is taxed differently from other types of investment income. A corporate tax rate of 33 1/3% is applied to Canadian source dividend income received by an investment holding company, other than those received from a company controlled by, or connected to, the investment holding company (see Table 1). This tax of 33 1/3%, commonly referred to as Part IV tax, is fully refundable to the investment holding company when the company pays a taxable dividend distribution to its shareholders. The net result then, is that the investment holding company pays no effective taxes on Canadian source dividend income (see Table 3) received and then paid to the shareholder in the same year.

Furthermore, to avoid double taxation, the non-taxable portion of capital gains earned in an investment holding company (ie. the 50% that is not taxed) is added to the company's "Capital Dividend Account (CDA)", which can be paid out as a tax-free dividend to the shareholder.

SHAREHOLDER TAXATION OF DIVIDEND INCOME

A special personal tax calculation is applied to dividend payments received by a shareholder from a Canadian investment holding company. The amount of the dividend received is first grossed up by 25% (to approximate the gross income of the investment holding company before corporate taxes) and the shareholder is taxed on this grossed up amount. The shareholder then receives a federal dividend tax credit totalling 16.67% of the dividend received before the gross up (or 13.33% of the grossed up dividend) (approximating the amount of federal taxes paid by the investment holding company). The provinces also allow a dividend tax credit for provincial tax purposes. The rationale behind this calculation is to tax the income earned by the holding company as if it was earned directly by the shareholder.

CORPORATE/SHAREHOLDER TAXATION VS. PERSONAL TAXATION

In theory, the dividend gross up and tax credit mechanism discussed above should result in equal amounts of taxes paid whether the income is earned personally or through a holding company. However, due to the impact of different provincial corporate tax rates, this is not the case. As shown in **Table 4**, the combined corporate/shareholder tax rate is greater than personal tax rate in every province. The combined corporate/shareholder tax rates refer to the scenario when investment income is originally earned in a corporation and then paid out to the shareholder in the same year.

The difference in the corporate/shareholder versus personal tax rate is outlined in **Table 5**.

For example, suppose an individual at the highest marginal tax rate residing in British Columbia is

INVESTMENT HOLDING COMPANY TIP

Consider paying out taxable dividends to shareholders each year from the profits of the investment holding company to reduce the net amount of corporate taxes paid.

Table 4 — Combined corporate shareholder (top personal marginal tax rate) tax rates on investment income — year 2005* (as of May 31, 2005)

INVESTMENT	INTEREST, RENT, FOREIGN INCOME, ROYALTIES	CAPITAL GAINS**	CANADIAN DIVIDEND
BC	48.0%	24.0%	31.6%
ALTA	40.0%	20.0%	24.1%
SASK	49.2%	24.6%	28.3%
MAN	52.1%	26.1%	35.1%
ONT	48.3%	24.2%	31.3%
QUE	51.6%	25.8%	32.8%
NB	51.8%	25.9%	37.3%
NS	51.6%	25.8%	33.1%
PEI	50.8%	25.4%	32.0%
NFLD & LAB	52.8%	26.4%	37.3%
YUKON	48.0%	24.0%	28.6%
NWT	47.0%	23.5%	29.6%
NUNAVUT	44.4%	22.2%	29.0%

* Adjusted for inability to obtain a full refund of the Refundable Dividend Tax On Hand (RDTOH) account.

** Assuming a capital dividend is paid prior to a taxable dividend.

Table 5 — difference between corporate/shareholder and personal tax rate on investment income — 2005 (as of May 31, 2005)

INVESTMENT	INTEREST, RENT, FOREIGN INCOME, ROYALTIES	CAPITAL GAINS	CANADIAN DIVIDEND
BC	4.3%	2.2%	0.0%
ALTA	1.0%	0.5%	0.0%
SASK	5.2%	2.6%	0.0%
MAN	5.7%	2.9%	0.0%
ON	1.9%	0.8%	0.0%
QUE	3.4%	1.7%	0.0%
NB	5.0%	2.5%	0.0%
NS	3.3%	1.7%	0.0%
PEI	3.4%	1.7%	0.0%
NFLD & LAB	4.2%	2.1%	0.0%
YUKON	5.6%	2.8%	0.0%
NWT	3.9%	2.0%	0.0%
NUNAVUT	3.9%	2.0%	0.0%

contemplating investing through an investment holding company. By referring to Table 1, the individual will observe that the corporate tax rates in British Columbia on interest, capital gains, and Canadian dividend income are 49.3%, 24.7%, and 33.3% respectively. If the individual were to earn this income personally, he or she would pay 43.7% (interest), 21.9% (capital gains), and 31.6% (Canadian dividends) (Table 2). Since the income earned by an investment holding company is taxed at a higher rate, it would not be possible for the individual to defer taxes through the use of an investment holding company.

The individual may also want to compare the overall tax rates of earning income through a holding company versus earning the same income directly. Income that is earned through an investment holding company will be taxed twice – once at corporate level, and again in the hands of the shareholder as taxable dividends. However, double taxation is minimized because, as previously mentioned, a portion of the corporate tax is refunded when the income is paid to the shareholder as a taxable dividend. The net corporate tax rates can be found in Table 3, and for British Columbia, these rates are 24.0% for interest income, 12.0% for capital gains income, and 0% for Canadian dividend income.

Table 4 shows that the combined corporate/ shareholder tax rates in British Columbia as 48.0% for interest, 24.0% for capital gains, and 31.6% for Canadian dividends. A comparison with personal tax rates shown in Table 2 will reveal that a higher tax rate will be applied to interest and

INVESTMENT HOLDING COMPANY TIP

You will generally pay an equal amount of taxes on taxable Canadian dividend income regardless of whether it is earned personally or through an investment holding company.

INVESTMENT HOLDING COMPANY TIP

You will generally pay more taxes on interest, foreign income, rent, royalty and taxable capital gains income earned through an investment holding company than if you earn such income personally.

capital gains income when such income is earned through a holding company. For Canadian source dividend income, the same tax rate will be applied whether the income is earned through a corporation or personally. The difference between corporate/shareholder tax rate and personal tax rates is shown in Table 5 and for this example, the corporate/shareholder tax rate on interest income exceeds that of personal tax rate by 4.3%, and for capital gains income, by 2.2%.

The above discussion can be summarized as follows:

1) An investment holding company can no longer be used as a tax deferral vehicle. Earning and retaining interest, rent, royalties, foreign income, taxable capital gains or Canadian dividend income in an investment holding company will result in a greater tax liability than if such income was earned personally.

2) A portion of the corporate taxes paid on interest, rent, royalties, foreign income and taxable capital gains income is refundable when the company pays a taxable dividend distribution to its shareholders, thereby reducing the net corporate taxes paid. However, the combined corporate/shareholder taxes paid are still greater than personal taxes paid on such income.

Canadian source dividend income received by an investment holding company from a non-related company is taxed differently from interest, foreign income, rent, royalty, and taxable capital gains income. This dividend income is subject to a 33 1/3% corporate tax. This tax is fully refundable when the company makes a taxable dividend distribution to its shareholder, resulting in no net corporate taxes paid by the investment holding company.

Even though the potential for tax deferral has been for the most part completely eliminated, investing through an investment holding company can provide other benefits. The following section illustrates some of the potential advantages to investing through an investment holding company.

3 › Advantages of investing using an investment holding company

INCOME SPLITTING

Certain income tax rules are in effect to discourage income splitting with spouses and related minor children through an investment holding company. One such rule is corporate attribution. Corporate attribution applies when an individual transfers or lends property to an investment holding company where one of the main purposes of the transfer is to benefit a spouse or a related minor child. In addition, the spouse or related minor child must own more than 10% of any class of shares in the investment holding company. If corporate attribution applies, then the individual who transfers or lends property to the corporation will be deemed to receive a continuing taxable benefit of up to the fair market value of the transferred or lent property multiplied by an annual prescribed interest rate.

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

Both the corporate attribution and split income rules do not apply to adult children. Therefore, it is possible to split income with adult children through the use of an investment holding company. Assets can be transferred into the holding company on a tax-deferred basis and the adult children can subscribe for shares of the company. Dividends can then be paid to the adult children and taxed in their hands.

As this area of taxation is quite complex, it is strongly encouraged that owners of holding companies discuss these issues with a qualified tax advisor prior to implementing any strategies.

ESTATE FREEZES

An investment holding company can also be used in a tax planning strategy called an “estate freeze”. One purpose of an estate freeze is to “freeze” a company’s share value for the original shareholders while ensuring that future increases in the fair market value of the company pass to the next generation or to other desired individuals. This way, the amount of estate and probate taxes for the original owner of the company can be minimized. Another use of an estate freeze may be to crystallize the $500,000 enhanced capital gains deduction on the sale of qualifying small business corporation shares. It should be noted that holding companies that are only used to hold investment portfolio assets will not qualify for the $500,000 enhanced capital gains deduction. As estate freezes are quite complex transactions, these should only be undertaken with the assistance of professional tax advisors.

U.S. ESTATE TAXES

Another reason for using an investment holding company could be to hold U.S. investments in order to shelter the Canadian shareholder from U.S. Estate Taxes. For more information on this topic, talk to your advisor.

PROBATE TAXES

An investment holding company may also reduce the cost of probate taxes. But it is unlikely that the probate taxes would be significant enough to justify establishing an investment holding company. The avoidance of probate taxes should be viewed as a secondary benefit of the investment holding company. More information on probate taxes is available from your advisor.

RSP CONTRIBUTION ROOM

The ability to contribute to an RSP is based on “earned income” which includes income from employment or business, rental income, or royalty income. If an individual has little or no such income, the individual may set up an investment holding company and pay himself or herself a reasonable salary or management fee so as to create earned income for RSP purposes.

AGE AMOUNT AND OLD AGE SECURITY

Both the age amount non-refundable tax credit and Old Age Security benefits are reduced when personal net income exceeds certain thresholds. For year 2005, this amount is $29,619 for the age amount and $60,806 for Old Age Security payments. If investment income is earned and retained in an investment holding company, personal income can be minimized so as to keep below these thresholds. Keep in mind however, that retaining investment income in an investment holding company will effectively result in a prepayment of taxes (ie. a portion of corporate taxes is refundable only upon payment of dividends to the shareholder). Also, as previously discussed, the combined corporate/shareholder taxes paid on investment income earned through an investment holding company will be greater than personal income taxes paid on such income.

In addition to the possibility of prepayment of taxes as well as a greater amount of overall taxes paid when investment income is earned through an investment company, the following are additional disadvantages of investing through an investment holding company.

4 › Disadvantages of investing through an investment holding company

CAPITAL LOSSES AND THE SUPERFICIAL/STOP-LOSS RULES

If portfolio investments that are in a loss position are sold by a shareholder to their holding company, and the holding company holds these investments for at least 30 days, any capital losses on the transaction may not be used by the shareholder on their personal income tax return. If this is the case, the capital loss to the shareholder will be denied and the cost base of the transferred property now located within the holding company will be increased by the amount of the denied capital loss. Basically this means that the cost base of the security to the shareholder rolls over to become the cost base of the security to the corporation. When the holding company subsequently sells the investment, if the security 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 their spouse 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 such time as the controlling shareholder or their spouse no longer owns that same security. 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 their spouse in this situation.

CAPITAL GAINS DEDUCTION

The disposition of the shares of a small business corporation may qualify for a lifetime capital gains deduction of up to $500,000 of gross capital gains. A small business corporation is generally considered as a Canadian-controlled private company that uses substantially all of its assets to earn active business income in Canada. Since an investment holding company derives most of its income from passive investments, it will generally not qualify as a small business corporation and the $500,000 capital gains deduction will not be available when its shares are sold.

An exception would be where the investment holding company's holdings were all or substantially all in an underlying Canadian small business corporation. If this were the case, then the sale of investment holding company shares may qualify for the $500,000 capital gains exemption.

INCORPORATION AND COMPLIANCE COSTS

Incorporation and legal fees may be incurred to establish an investment holding company. In addition, there are costs and inconveniences associated with company ownership. The company must be incorporated and company minutes must be kept. Shareholder agreements may be required and annual financial statements and tax returns must be prepared and filed on a timely basis.

CAPITAL TAX

In a number of provinces, including Saskatchewan, Manitoba, Ontario, Quebec, New Brunswick, and Nova Scotia, an annual tax is levied on corporations with assets exceeding certain thresholds. This provincial tax can range anywhere from 0.30% to 0.60% of the taxable capital. In addition every corporation in Canada with taxable capital exceeding $50,000,000 is also subject to the federal large corporation tax. The large corporation tax rate is currently at 0.175% (2005) of the taxable capital, which is in addition to the provincial capital taxes imposed.

TAXES AT DEATH

Individuals owning shares in holding companies at death can be subject to double taxation. First, the deceased will be taxed on the gain on death on the deemed disposition of the shares of the holding company. The amount of the capital gain is based on the fair market value of the shares of the holding company, which in turn get their value from the fair market value of the investment portfolio in the holding company. Then, when the holding company sells the underlying asset or when the corporation is wound up, capital gains tax may be paid at the corporate level. Thus the increase in value of the portfolio in the holding company may be subject to taxation at both the shareholder level and the corporate level. However, it may

be possible to defer or eliminate this potential double tax if the shares of the holding company were to pass to a surviving spouse or a spousal trust, or if the holding company was wound up within the first taxation period of the estate.

In the case of a spouse or a spousal trust, the shares of the holding company can be transferred to the spouse or spousal trust on a tax deferred basis upon the death of the shareholder, thereby avoiding the triggering of any capital gains tax at the time of death. If capital gains tax was paid in the year of death, then on the subsequent wind-up of the holding company, the redemption of the holding company shares will likely result in a capital loss. If so, this loss can be brought back to offset the gains realized in the year of death but only if the loss were realized within the first taxation year of the estate.

TRANSACTIONS BETWEEN A SHAREHOLDER AND THE INVESTMENT HOLDING COMPANY

Certain tax rules govern transactions between a shareholder and the investment holding company. These rules are designed to prevent the distribution of the accumulated surplus of the holding company to the shareholder (other than by way of taxable dividends) while the holding company continues to operate. One of these rules relates to shareholder benefits. Shareholder benefits are construed very broadly to include any benefit or advantage conferred to a shareholder by the holding company and, subject to some exceptions, include any transfer of corporate property to the shareholder for less than equivalent consideration exchanged 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 shareholder may be required to include the $50 difference as income on the personal tax return.

Another rule that is directed at preventing the distribution of corporate surplus to a shareholder relates to shareholder loans. It would be possible, if not for this rule, to escape tax on the distribution of corporate surplus by simply lending the funds of the holding company to a shareholder with the shareholder never repaying the borrowed funds. This rule requires that, subject to some exceptions, the shareholder or a member of the shareholder's family include as income the principal amount of all loans received from the holding company during the year. Subsequent repayment of the loan may be deducted in the year that the repayment is made, unless the repayment is considered as part of a series of loans and repayments.

EXISTING INVESTMENT HOLDING COMPANIES

The current tax disadvantage of earning investment income through a holding company may prompt many shareholders to consider winding down their investment holding companies. If so, a number of factors should first be considered. A shareholder may not want to wind down the holding company if there are other reasons for keeping the investment holding company as described earlier. If there are significant accrued gains on the investments in the investment holding company, the tax cost of a wind-up can be significant.

Another factor that the shareholder should also consider is future tax rates. A number of provinces have announced a reduction of corporate tax rates over the next several years. For example, Alberta has announced that it intends to cut its corporate tax rates over the next couple of years. Absent any changes in personal tax rates, it is anticipated that the combined corporate/shareholder tax rates will be lower than personal tax rates in Alberta within the next couple of years.

5 › Conclusion

The use of an investment holding company may serve various purposes and provide numerous benefits. In the past, a substantial benefit existed in the form of a tax deferral. Now there is little, if any, tax advantages to using holding companies in most provinces.

For individuals with existing holding companies, although there is no longer a tax benefit, this should not necessarily motivate them to wind up these companies especially where the dissolution may result in the realization of previous tax deferrals and existing unrealized capital gains. Individuals should consult with a qualified tax advisor to determine if an investment holding company should be set up, or an existing holding company should be wound up and dissolved.

Notes

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