RBC Wealth Management Services

THE NAVIGATOR

Investment Holding Companies

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 holding company, the total corporate and personal tax burden should be approximately the same amount as what the shareholder would have paid if the investment income was earned directly. Accordingly, there should be no material tax deferral possible on passive income. 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 is slightly higher than the personal tax rate for investment income. So why would anyone consider having a holding company?

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.

Advantages of Using an Investment Holding Company

Estate Freezes

An investment holding company can be used to implement an estate freeze. One purpose of an estate freeze is to "freeze" a company's share value for the original shareholders and ensure that future increases in the fair market value of the company pass to the next generation or to other desired individuals. This way, the capital gains triggered on the deemed disposition upon death and probate taxes for the original owner of the company can 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 may be to crystallize the capital gains deduction on the sale of qualifying small business corporation shares. It should be noted that holding companies that are used only to hold an investment portfolio do not qualify for the capital gains deduction.

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 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

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

- Any actual interest payments 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 the kiddie tax). Under this rule, a minor child who receives certain dividend payments from a Canadian corporation whose stock is not listed on a stock exchange (i.e. 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. Assets can be transferred to 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.

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. However, these 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

Where the holding company is the parent company of an operating company, dividends paid by the operating company to the parent holding company are generally received tax-free. This can be beneficial if you want to remove funds from the operating company but don't necessarily want to pay personal tax on the funds distributed from the operating company. A couple of situations where you may wish to remove funds from an operating corporation are discussed in the next sections.

Creditor Protection

If you have excess earnings in your operating company each year, you may want to pay the excess funds to a holding company as a tax-free inter-corporate dividend, which

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may protect those earnings from creditors of your operating company. If necessary, 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.

Tax-Efficient Investment

To diversify, you may consider investing some of your excess earnings from your operating company in other assets. You can do this by paying tax-free dividends from your operating company to a holding company and then having the holding company make the other investments. If instead you paid the excess earnings from the operating company to yourself to make those investments personally, you would first have to pay tax on the funds you receive from the operating company, which would leave you with less to invest. By having a holding company, you can defer a layer of tax, making investment more tax efficient. There could be further tax efficiencies if the holding company invests in tax-deferred securities (e.g. deferred capital growth and corporate class mutual funds).

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, speak with your qualifed tax advisor.

Probate Taxes

An investment holding company may also reduce the cost of probate taxes. However, 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 using an investment holding company. More information on probate taxes is available from your RBC advisor or your qualified tax advisor.

Control of Amount and Timing of Income

Both the age amount non-refundable tax credit and Old Age Security (OAS) benefits are reduced when personal net income exceeds certain thresholds. If investment income is earned and retained in an investment holding company, you may be able to minimize your personal income to keep it below those thresholds. Keep in mind however that keeping

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investment income in an investment holding company may effectively result in a prepayment of taxes (i.e. a portion of corporate taxes is refundable only upon payment of taxable dividends to the shareholder). This can be mitigated by investing in tax-efficient investments (e.g. deferred capital growth and corporate class mutual funds). 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 (New Brunswick and Ontario are the two exceptions).

Disadvantages of Using an Investment Holding Company

Capital Losses and the Superficial/Stop-Loss Rules

If portfolio investments 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 arising from the transaction cannot be claimed by the shareholder on their personal income tax return. If this is the case, the shareholder's capital loss 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 shareholder's security rolls over to become the cost base of the security now held within the holding company. 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 anyone affiliated with them 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 the affiliated person 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 the affiliated person in this situation.

Losses Trapped

Losses that arise in a corporation can only offset earnings in that corporation. Losses earned in a corporation cannot be transferred to its shareholders. However, if you own investments personally, you can utilize losses and capital losses that arise against other sources of income and capital gains or against future earnings and future capital gains.

Capital Gains Deduction

The disposition of the shares of a small business corporation may qualify for the capital gains deduction. Generally, a small business corporation is a Canadian-controlled private corporation that uses substantially all of its assets to earn active business income 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 deduction is not available when its shares are sold.

It may be necessary to reorganize the holding company and the target operating company in order to access the capital gains deduction.

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

An exception is 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, then the sale of investment holding company shares may qualify for the capital gains exemption. It is likely that a purchaser may not be interested in purchasing the shares of a holding company. Therefore, it may be necessary to reorganize the holding company and the target operating company in order to access the capital gains deduction.

Incorporation and Compliance Costs

Incorporation and other legal fees may be incurred to establish an investment holding company. In addition, there are costs and administrative requirements associated with corporate 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.

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 investment portfolio in the holding company. Then, when the holding company sells the underlying asset or when the corporation is wound up, there may be capital gains tax to 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 pass to a surviving spouse or a spousal trust, or if the holding company is wound up within the first taxation year 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 triggering 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. This loss can be carried back to offset the capital gains

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realized in the year of death but only if the capital loss is realized within the first taxation year of the estate.

hTransactions Between You and Your Holding Company

Certain tax rules govern transactions between a shareholder and their company. These rules are designed to prevent the distribution of the accumulated surplus of the company to the shareholder (other than by way of taxable dividends) 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 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 their 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 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.

A shareholder may not want to wind up the holding company if there are other reasons for keeping the investment holding company.

Existing Investment Holding Companies

The current slight tax disadvantage of earning investment income through a holding company (New Brunswick and Ontario being the exceptions), may prompt many shareholders to consider winding up their investment holding companies. However, a number of non-tax factors should first be considered. A shareholder may not want to wind up the holding company if there are other reasons for keeping the investment holding company. For example, if there are significant accrued gains on the investments in the investment holding company, the tax cost of a wind-up may be significant and thus a wind up may not be advantageous.

Conclusion

Although there may no longer be a tax deferral benefit to investing through a holding company, the use of an investment holding company may serve various other purposes. These advantages should be considered.

If you have an existing holding company, although there may no longer be a tax advantage, this should not necessarily motivate you to wind up your company, especially 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.

Please contact us for more information.

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