The Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Investment holding companies

When it comes to earning investment income through a corporation, planning can often be complex, as you have to consider the taxes payable in the corporation as well as the taxes payable when withdrawing the funds from the corporation. To help paint a clearer picture, this article identifies and discusses situations where the use of an investment holding company may be beneficial. It also outlines the possible drawbacks of using a holding company. In addition, this article provides some ideas to consider when creating your estate plan that includes an investment holding company.

Any reference to a spouse in this article also includes a common-law partner.

What is an investment holding company?

An investment holding company is not a defined term in the Income Tax Act. It's a term used to describe a corporation that doesn't have any active business operations itself. A holding company can own shares of a private corporation with active business operations. It can also hold passive assets, such as publically traded securities, bonds, real estate and so on.

Investing through a holding company

The Canadian tax system is designed to be neutral between investment income that is earned personally and investment income that is earned through a corporation. What this means is that after a corporation pays tax on its investment income and a shareholder pays personal tax on dividends received from the corporation, the total corporate and personal tax payable should be the same as the tax an individual would pay if the investment income was earned personally. Accordingly, there should be no material tax advantage or disadvantage to earning passive income through a corporation. With that said, however, the Canadian tax system is not perfect and there is currently a tax cost to earning investment income through a corporation in all provinces and territories. So, you may be asking, why would someone consider having an investment holding company?

Benefits of using a holding company

There are several potential benefits to using an investment holding company.

Deferring personal tax

A common corporate structure involves a holding company owning shares of an operating company. Integrating a holding company into

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an existing corporate structure may be advantageous if you want to move excess funds out of your operating company but don't necessarily want to pay personal tax on the funds.

Let's say, for example, you wanted to extract funds out of your operating company to invest. If you were to pay the excess earnings from your operating company to yourself, personally, you'd have to pay personal tax first, leaving less to reinvest. If instead you had a holding company, it may be possible, in certain circumstances, to move excess earnings from your operating company to your holding company as an inter-corporate tax-free dividend. As such, the use of a holding company can defer personal tax until later, leaving more funds for reinvestment.

Keep in mind, however, that in every province and territory, there is currently a cost to earning investment income (except taxable Canadian dividends) through a corporation versus earning the income personally. This is because the combined corporate and personal tax that you will have to pay on this income (once it is ultimately paid to you as a dividend) is higher than the personal tax you would pay had you originally earned the income personally. And, in addition to the cost of earning investment income through a corporation, there may also be a slight prepayment of taxes on investment income in most provinces and territories (except Ontario, Quebec, and New Brunswick if you are at the highest marginal tax bracket) due to the differences between corporate and personal tax rates.

Taxable Canadian dividends earned through a corporation are tax neutral, but may result in a slight prepayment of taxes in most provinces and territories if not paid out as a dividend by the corporation in the year they are received. The prepayment of taxes occurs if your personal tax rate on this type of income is lower than the corporate tax rate. There will be a prepayment of taxes on eligible Canadian dividends earned through a corporation in most provinces and territories even if you are at the highest marginal tax rate personally and if the dividend income earned in the corporation is not paid out in the same taxation year.

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 to protect those earnings from creditors of your operating company. If your operating company needs working capital, the holding company can lend that money back to your operating company on a secured basis to maintain the potential protection from creditors. Similarly, in the case of rental operations, holding rental properties within a corporation may limit your personal liability and provide some creditor protection.

When it comes to creditor protection, it's essential that you speak with a qualified legal advisor about the options available to you. You may also want to speak to a qualified tax advisor about the tax implications of moving the funds from your operating company to your holding company.

Purifying your corporation

If you sell shares of a qualifying small business corporation (QSBC), you may be able to save a significant amount of tax by claiming the lifetime capital gains exemption (LCGE). Although a detailed discussion of the conditions to be QSBC shares is beyond the scope of this article, we will address two of the conditions here. First, at the time of disposition of your shares, the corporation must be a small business corporation (SBC). An SBC is a Canadian-controlled private corporation (CCPC) where all or most (90% or more) of the fair market value (FMV) of the assets are used in an active business carried on primarily in Canada. Second, throughout the

24 months immediately before the shares are disposed of, the corporation must be a CCPC and more than 50% of the FMV of the assets of the corporation must be used in an active business carried on primarily in Canada. As such, if you have an operating company where more than 10% of the FMV of the assets are not used in active business (for example, your corporation holds a substantial amount of portfolio investments) at the time of disposition or where 50% or less of the FMV of the assets are used in an active business in the 24 months immediately before the disposition, then your shares may not qualify as QSBC shares and you will not be able to claim the LCGE if you sell the shares.

To keep your operating company onside with the QSBC requirements, you may want to remove excess funds (not needed for active operations) on a regular basis, or "purify" your corporation, prior to selling the company's shares to ensure that you can claim the LCGE. You can generally remove the excess funds in your operating company by transferring them to an investment holding company on a tax-deferred basis. Speak with a qualified tax advisor to determine how best to accomplish this.

Controlling the amount and timing of income

By investing in a holding company, you have the flexibility in determining when and how much to pay yourself personally. This flexibility may be useful, for example, if you wish to manage your personal marginal tax rate and minimize income that would be taxed at the highest marginal tax rate. In addition, 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. By retaining income in an investment holding company, you may be able to manage your personal income to keep it below these thresholds.

An investment holding company may also provide flexibility in the situation where you own an operating company along with other shareholders and the operating company pays out income each year. If you wanted to receive your share of the income but did not want to receive it personally yet, having a holding company own shares of the operating company could provide you with this flexibility.

Lastly, the ability to control the timing of when you receive income personally may allow you to avoid the requirement to pay personal tax instalments, for example. You can choose to pay yourself dividends every second year rather than every year. This is because it's possible to base instalments on either the previous year's taxes owing, or the current year's expected liability. If you have little or no tax liability every second year, you can base your instalments annually on the year you expect to have little income.

Implementing an estate freeze

If you have a personal investment portfolio, or other passive assets such as a rental property, that you expect to keep growing in value, you can implement an estate freeze to lock-in or "freeze" the value of your appreciating assets and transfer the future growth to other individuals, usually family members, as part of your estate plan. An estate freeze can be accomplished by using an investment holding company whereby you exchange your investments for property with no growth potential, such as fixed-value preferred shares of the investment holding company. This exchange may be done without triggering immediate tax consequences. And, in addition to the tax-deferral, freezing the value of your assets allows you to plan for the tax that will be payable upon the eventual disposition of your shares, including the deemed disposition on death. You can then issue new growth shares of your investment holding company to your family members directly, or through a family trust, which may provide more flexibility. This will allow the future growth value of your assets to accrue to your family members and only be taxed when they in turn dispose of their shares. When considering an estate freeze, it is important to note that the strategy generally only makes sense when there is an expectation that your assets will continue grow in value and where there is a clear successor or next generation of owners.

Income splitting

If you have an investment holding company, you may be able to pay dividends to family members who are shareholders of the corporation. If your family members have little or no other income, it may be possible for these dividends to be taxed at their lower marginal tax rate. However, it's important to note that there are "tax on split income" (TOSI) rules as well as corporate attribution rules which limit splitting certain types of income from a corporation with family members.

Although the next section provides an overview of the TOSI rules, we want to emphasize that the application of these rules is not clear where a corporation earns only passive investment income. To determine if the TOSI rules apply to your specific situation, please consult with a qualified tax advisor.

The TOSI rules

The TOSI rules are designed to discourage income splitting with family members who don't meaningfully contribute to the business activities of a private corporation. The TOSI rules were commonly known as the "kiddie tax" rules, because they limited splitting certain types of income received from a private corporation with minor children. However, as of January 1, 2018, the TOSI rules have been expanded to apply to any Canadian resident age 18 or over, as

well. This has significantly curtailed the ability to split income.

The TOSI rules apply to many types of income received from a private corporation, including interest, dividends, shareholder benefits and certain capital gains. Where TOSI applies, the income is subject to tax at the highest marginal rate, regardless of the individual's actual marginal tax rate. In addition, the individual who receives split income cannot reduce the tax on this income by claiming personal tax credits other than the dividend tax credit, the foreign tax credit and the disability tax credit. As a result of these tax implications, income splitting becomes ineffective.

The TOSI rules provide some exclusions, which differ depending on the age of the individual receiving the income. For example, there is an exclusion available for business owners who are age 65 or older, which effectively allows them to income split with their spouse. The exclusions are generally more restrictive for minors. For more information on the TOSI rules, please ask an RBC advisor for our article discussing income splitting through private corporations.

The corporate attribution rules

If you own an investment holding corporation and would like to direct income earned in the corporation to a family member, you should also be aware of the corporate attribution rules. Corporate attribution generally applies when an individual transfers or lends property to a corporation and one of the main purposes of the transfer or loan may reasonably be considered to reduce the transferor or lender's income and to benefit a spouse or a related minor child (which includes a grandchild, niece or nephew). It is relatively easy to fall into these rules. For example, some of the most common methods used to implement an estate freeze are considered a transfer of property to a corporation.

If corporate attribution applies, the individual who transferred or loaned the property to the corporation is deemed to have received interest income in the year equal to the CRA's 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 received in the year by the individual in respect of the transfer or loan;
- Taxable dividends (grossed-up actual dividends) received by the individual in the year on shares that were received from the corporation as consideration for the transfer; and
- Taxable dividends paid to your spouse or a related minor that is subject to TOSI.

Corporate attribution does not apply to an SBC but would generally be a concern for investment holding corporations that hold passive investment assets exceeding 10% of the FMV of its total assets.

There may be strategies to get around the application of the corporate attribution rules, however, these are beyond the scope of this article. Since the application of corporate attribution is quite complex, it's strongly recommended that you discuss these issues with a qualified tax advisor prior to implementing any income splitting strategies involving an investment holding corporation.

Minimizing U.S. estate taxes

U.S. investments (such as shares of U.S. public corporations) that you hold in a Canadian corporation are generally not subject to U.S. estate tax, provided you are not a U.S. person. Therefore, it may be possible to reduce or eliminate your U.S. estate tax exposure by holding certain U.S. assets in a Canadian holding company. That being said, keep in mind that earning U.S. dividends in a corporation may result in a significantly larger combined corporate and personal tax liability than holding these assets personally due to the way foreign dividend income is taxed in a corporation.

Before using a Canadian corporation to hold U.S. assets, ensure that the strategy is reviewed by a qualified cross-border tax advisor who can evaluate the risks from both a Canadian and U.S. perspective to determine if using a Canadian corporation will achieve your desired objectives.

Minimizing probate taxes

If you own shares of an investment holding company, you may be able to reduce the probate taxes on death by using what's called a "multiple Wills strategy," depending on your province or territory of residence. This is because under provincial corporate statutes, it may be possible to transfer share ownership on death without probate.

The multiple Wills strategy involves having a "primary" Will that deals with assets that require probate to transfer ownership, such as a bank account or an investment portfolio, and a "secondary" Will to transfer assets that typically do not require probate, such as artwork or private company shares. By separating assets in this way, you may avoid paying probate on the assets that do not otherwise require it.

Note that the probate tax savings alone may not be significant enough to justify establishing an investment holding company. The reduction of probate taxes should be viewed as a secondary benefit of using an investment holding company. In addition, there may be circumstances where the secondary Will does need 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.

For more information on whether a multiple Wills strategy makes sense for you, please speak with a qualified legal advisor.

Considerations in using a holding company

While having a holding company may provide certain advantages, you need to weigh these benefits against the potential disadvantages, such as the ongoing accounting and legal costs associated with having a corporation.

Restricted access to the small business limit

If you have an active operating company that's a CCPC throughout the tax year, it may benefit from the federal small business deduction, which is a low tax rate on the first $500,000 of active business income (known as the "business limit"). However, for tax years that begin after 2018, if a CCPC, and any associated corporations, earn between $50,000 and $150,000 of passive investment income in a year, the CCPC's federal business limit for the following year will be reduced. The CCPC's business limit will be eliminated where passive income exceeds $150,000. This reduction in the business limit may result in higher corporate taxes being paid on your operating company's active business income.

These rules discourage accumulating excess income (over and above what is needed for the continued operations of the business) in an operating company or an associated holding company. So if you have an investment holding company that controls an operating company, for example, the two corporations would be associated for tax purposes. And in this case, you may want to minimize the impact that the level of passive investment income earned in both of your corporations has on the small business limit of your operating company. If you only have a holding company that is not associated with any operating company, these passive investment income rules do not affect your holding company.

Restricted personal use of corporate funds

If you were to invest personally, all the investment income you earned would be taxed in your hands annually. As such, you would be able to use the after-tax returns however you wish. On the other hand, if you invest within a holding company, the after-tax returns belong to the corporation and you cannot use the corporate funds for personal expenses unless you first withdraw the money from the corporation. The tax implications of the withdrawal will depend on how you withdraw the funds from the corporation (for example, as a regular dividend versus a capital dividend).

Restricted use of losses

If you invest personally, any capital losses you realize may be used to offset capital gains and reduce your taxable income for the current year. However, if you invest in a holding corporation, any losses realized in the corporation must be applied against the corporation's capital gains and can't be used to offset your personal income. That being said, whether you incur these capital losses personally or through your corporation, if you or your corporation can't use the losses in the year they are incurred, they're not completely lost. Capital losses can be carried back to any or all of the three immediately preceding taxation years as well as carried forward indefinitely to use against future capital gains.

Restricted access to the LCGE

As previously mentioned, if you sell shares of a QSBC, you may be able to save a significant amount of tax by claiming the LCGE. Since an investment holding company invests in mostly passive assets, it generally doesn't qualify as a QSBC. As a result, the LCGE is generally not available to you if you sell shares of an investment holding company.

But, what if the only asset your holding company owns is 100% of the shares of a QSBC? Unfortunately, if your holding company were to sell the shares of the QSBC that it owns, it would not be able to claim the LCGE since only individuals (and not corporations) can claim the LCGE. However, with this structure, your investment holding company may itself be a QSBC since its only asset is QSBC shares. If you were able to sell your shares of your investment holding company, you may still qualify for the LCGE. That being said, a purchaser would generally not be interested in purchasing the shares of a holding company and you may have to reorganize your corporate structure before selling to access the LCGE.

Increased complexity and cost

In addition to the increased complexity of a corporate structure, investing through a holding corporation may require you to adhere to a number of corporate formalities. For example, the directors of the holding corporation will still need to pass a resolution to declare and pay dividends. A corporation is also subject to greater regulation and compliance; for instance, your holding corporation will have to hold annual shareholder meetings and maintain corporate records.

The administrative, legal and accounting costs associated with establishing and maintaining a holding corporation are also factors to consider. When setting up a holding corporation, certain documents must be filed with the government, including articles of incorporation. If you ever make changes to the structure of your corporation, articles of amendment will need to be filed as well. In terms of ongoing professional fees, your holding corporation will incur costs to prepare financial

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statements, file an annual corporate tax return and tax slips for any dividends paid.

Double taxation at death

If you own shares of a holding company, you and your estate may be subject to double taxation at death. First, you're taxed on the capital gain arising from the deemed disposition of your holding company shares at death. The amount of the capital gain is based on the FMV of the shares of the holding company, which in turn derive their value from the investments and assets within the holding company. Second, distributions from the corporation to your estate or other beneficiaries, generally in the form of dividends, may result in both corporate tax on the disposition of assets inside the corporation and then personal tax on the dividend.

The gain on the investments within the holding company may therefore be taxed twice – once as a capital gain on the deemed disposition at death and again as combined corporate and personal tax on the disposition of the assets inside the corporation and the distribution as a dividend to your estate or beneficiaries.

It may be easier to illustrate this double tax issue with a numerical example. We have assumed a personal tax rate of 50% on ordinary income, 45% on non-eligible dividends and a corporate tax rate of 50% on investment income. As you can see, if the investments are held personally at death the total tax paid would be $250. If the same investments were held in a holding company at the time of death then the total corporate and personal tax paid would be $529.

Total taxes paid on death if investment held personally		Total taxes paid on death if investment held in a holding company		
Personal tax at death on deemed disposition		**Personal tax at death on deemed disposition**		
FMV at death	$1,001	FMV at death		$1,001
ACB	1	ACB		1
Capital gain	1,000	Capital gain		1,000
Taxable capital gain	500	Taxable capital gain		500
Personal tax @ 50%	**$250**	**Personal tax @ 50%**	A	**$250**
		Corporate and personal tax on disposition of assets and distribution to estate/beneficiary		
		FMV		$1,001
		ACB		1
		Capital gain		1,000
		Taxable capital gain		500
		Corporate tax @ 50%	B	250
		After-tax funds		751
		Refund of RDTOH*	C	153
		Funds available for distribution		904
		Tax-free capital dividend**		500
		Taxable dividend		404
		Personal tax @ 45%	D	182
		Total corporate and personal tax (A + B – C + D)		**$529**

Notes:

** RDTOH - Refundable Dividend Tax On Hand - this is the portion of corporate tax paid that is refundable to the corporation when a taxable dividend is paid out to the shareholders.*

*** This is the non-taxable portion of the capital gain that can be paid out as a tax-free capital dividend.*

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 post-mortem tax-planning techniques that may reduce or eliminate this double taxation. For example, if your corporation is wound up by your estate, it may result in a deemed dividend on the redemption of the shares and a capital loss to the estate. If this is done within the first taxation year of the estate, the estate may be able to carry back the capital loss realized on the wind-up to your final tax return to offset the capital gain realized on the deemed disposition of your shares. In this case, the double taxation may be reduced by the loss carry-back, since the net result is only the corporate tax on the disposition of assets in corporation, if any, and the tax on the dividend to your estate.

There are more complex post-mortem tax planning techniques available that can be used to further reduce or eliminate the double tax issue or where the loss carry back strategy just discussed is not available, but these are beyond the scope of this article. For more information, talk to a qualified tax advisor.

Estate planning considerations

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 in order 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 you pass away. 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 or territorial intestacy laws. When drafting your Will, consider whether you want the shares to pass outright to your named beneficiaries or for the company to be wound up. You may also want to consider the tax implications of these different options to your estate and beneficiaries. To ensure you have properly addressed all estate planning issues with respect to your investment holding company, speak with a qualified legal and tax advisor.

Conclusion

Although there may no longer be a tax benefit to investing through a holding company, the use of one may serve various other purposes, such as creditor protection. If you're thinking of setting up an investment holding company, remember to give careful thought to both the benefits and the potential costs.

If you have an existing holding company, you should periodically weigh the reasons for maintaining it against the reasons for dissolving it. For example, you may not want to wind up your holding company if the dissolution would result in the realization of previous tax deferrals and accrued capital gains.

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