

WOOD GUNDY

# BENEFITS OF A HOLDING COMPANY

Your business is up and running. However, with increasing profits comes the potential for higher capital gains when the business is eventually sold. When planning for the growth of your business, it is essential to consider tax implications that can affect your enterprise. Holding companies can be an attractive alternative to preserve the profits of a relatively mature, growing business. This type of corporation allows you to implement tax-saving strategies now and for future generations.

## What is a holding company?

Generally, the holding company itself does not produce goods and services, but exists only to hold shares of another company.

A holding company is a parent corporation that owns enough voting stock in another company to control its board of directors, thereby controlling its policies and management. Most importantly, a holding company is a company that is interposed between the owner and the active business, which allows profits to be flowed up to and protected in the holding company.

## Key benefits

Through a holding company, there are a variety of strategies that business owners can take advantage of that are not typically available through a simple corporate structure.

### Creditor protection

As a business owner, creditor protection is an important consideration. Even in the best-planned businesses, unforeseen circumstances can arise – markets can dry up, costs can increase or competing products or vendors can challenge your market share. Setting up a holding company may help protect assets in a worst-case business scenario.

It is preferable to implement these plans while the business is solvent and there are no pending claims against it. Once claims have been filed, it is often too late to move assets beyond the reach of creditors.

By creating a holding company, you can move retained earnings from the operating company by paying tax-free inter-corporate dividends to the holding company. The holding company can then reinvest these dividends and build up assets where they may be safe from creditor claims.

Should the operating company require funds, the holding company can provide a secured loan by lending the money back to the operating company under a general security agreement. This is a legal document that allows the lender to seize company assets to pay the loans in default. This allows the holding company lending the money a priority claim to the assets ahead of certain other creditors in the case of bankruptcy.

There are detailed rules and exceptions to the rules of prioritizing securities interests, including “super-priority” interest for unpaid wages and taxes payable. A lawyer must be consulted in this regard.

### Income splitting

Holding companies may allow a family to split dividend income among adult family members as a tax minimization strategy. The “kiddie tax” prevents you from using this strategy to pay dividends to minor children until they are 18 years of age. If your corporation carries on an active business, paying a tax-free inter-corporate dividend to a holding company can protect that cash from creditors, and may provide flexibility in timing the payment of income to the business owner. Family members including adult children can subscribe for shares in the holding company, allowing for the dividends to be taxed in their hands, and at their marginal tax rate.

## Additional tax incentives

### Life insurance tax strategy

By utilizing surplus cash in a holding company to purchase a tax-exempt permanent insurance product (such as a whole life or universal life insurance policy) with the holding company paying the premiums and named as the beneficiary, you may be able to accumulate funds sheltered from tax inside the policy. Upon death, insurance proceeds pass tax-free to the holding company and are added to a notional tax account called the Capital Dividend Account (CDA) that tracks, among other things, the tax-free portion of capital gains, as well as the death benefit associated with the life insurance policy. A positive CDA balance can be used to declare a tax-free capital dividend to the shareholder(s).

The 2016 federal budget has proposed that only the portion of the policy benefit received by the corporation, or partnership, that is in excess of the policy's adjusted cost basis may be added to the CDA. Therefore, the tax-free portion of life insurance proceeds may be limited to the adjusted cost basis of the policy for individuals who passed away after March 21, 2016. Speak with a tax professional to understand the implications of using this type of strategy.

### U.S. estate taxes

It may be possible for a Canadian resident to shelter U.S. investments from U.S. estate taxes if the investment are held in a Canadian company. However, as this is a complex strategy, it should only be considered with the advice of a professional international tax consultant.

## Considerations

### Lifetime Capital Gains Exemption

The Lifetime Capital Gains Exemption (LCGE) can be claimed to offset a capital gain on the sale of shares of a Qualified Small Business Corporation (QSBC). Each family member who owns shares of a QSBC may be able to claim a \$824,176 capital gains exemption (indexed to inflation after 2016). As it only applies to shares, businesses must be incorporated to qualify. There is no size restriction; however, the business must meet the definition of a Canadian Controlled Private Corporation (CCPC).

To determine if a corporation is a QSBC, there are two tests. The first test considers whether the corporation was a small business corporation when the sale took place. In order to qualify as a small business corporation, in addition to your business being a CCPC, at least 90% of the fair market value of the corporation's assets must be used in an active business carried on primarily in Canada. Under the second test, in the 24 months preceding the sale of the business, more than 50% of the fair market value of the corporation's assets must have been used in an active business carried out primarily in Canada. Your shares of the corporation cannot have been owned by anyone other than you or a person related to you (such as your spouse or child) during this 24-month period.

Using a holding company to own operating company shares adds complexity around claiming exemptions. The holding company cannot claim the exemption on the sale of the operating company shares as the LCGE is only available to individuals, not corporations. Upon the sale of the holding company shares, while the LCGE may be available, the rules for determining whether the shares qualify as QSBC shares are extremely complex. Professional tax advice must be sought.

## Estate freeze

An estate freeze can be implemented to transfer ownership of a corporation to the next generation. This strategy may help to reduce the amount of taxes that are payable on the income from the shares. "Freezing" a company's share value for the original shareholders (for example, a parent) ensures that future increases in the fair market value of the company can be passed on to the next generation.

In one estate freeze model, a parent transfers shares in the operating company to a holding company, and in return, the parent receives fixed value "freeze" shares from the holding company. A holding company may be used to hold shares of an operating company from start up, however, a holding company is often set up when the business is more established during the course of an estate freeze.

If the only value received by the parent for the original shares is the freeze shares, capital gains will not be triggered. It may also be possible to use the LCGE on an estate freeze. A parent who has capital losses could elect to transfer the shares at an amount in excess of the adjusted cost base, triggering a capital gain that could offset the capital losses incurred. Children are then able to subscribe to the common shares of the holding company at a nominal subscription price.

## Sale of the company

If a holding company sells shares of an operating company, the capital gain is recognized by the holding company and no capital gains exemption can be claimed. The sale must occur at the holding company level for capital gains to be taxable to the parents or children, thereby resulting in potential tax savings using the capital gains exemption.

If the company is not sold during the parents' lifetime, income tax and probate fees (in applicable provinces) are restricted to the value of the frozen interest in the company. Any capital gains (fair market value, less adjusted cost base) arising on a disposition or deemed disposition (i.e., on death) of the parents' "freeze" shares will be taxed at the parents' marginal tax rate for capital gains.

An estate freeze strategy using a holding company can be a complex undertaking. Keep in mind the method described above is only one way to implement an estate freeze. You should consult a tax professional to determine if an estate freeze strategy can be applied to your business.

**For more information on how a holding company may be beneficial to your business, speak to a CIBC Wood Gundy Investment Advisor.**