Holding Companies - When and How to Use Them to Your Advantage

Wealth Management Taxation, The Bank of Nova Scotia

Holding companies, or "holding corporations", can exist for a number of reasons. A holding company can be used to hold a portfolio of investments, or, as an intermediary between individual shareholders and another corporation carrying on an active business. In deciding whether to put a holding company to use, there are a number of potential benefits and disadvantages to consider.

Benefits of holding companies

Tax deferral opportunity

The value of an opportunity to defer tax can be significant. Each dollar that is not lost to income tax can be invested and potentially grow over time.

In the context of an active business operated by a corporation, when after-tax corporate earnings are not required by individual shareholders to fund personal expenses, tax at the individual level on distributions from the corporation can be deferred, and the funds can be invested within the corporation, allowing for investment growth. Since income from an active business is generally taxed at preferred rates, the advantage can be significant.

Asset protection

There are a number of reasons why it may not be wise to keep passive investments within the same corporation as an active business. Firstly, the passive investment assets may be subject to claims of the company's creditors. One potential solution might be the introduction of a second corporation inbetween the active business corporation and individual shareholders. Individual shareholders would now own shares of the holding corporation, and the holding corporation would own shares of the active business corporation.

Excess funds that are not needed in the business would then flow to the holding corporation in the form of dividends from the active business corporation. As long as the holding corporation owns shares in the capital of the active business corporation with at least 10 percent of "value" and voting rights, dividends can generally flow tax-free between the two corporations.

There are additional rules impacting the amount of dividends that can flow between the corporations without incurring tax, and rules surrounding the taxation of distributions to a holding company when done in anticipation of the sale of a business. These rules are complex and should be discussed with a tax professional.

In the case of a professional corporation, it is important to note that the implementation of a holding corporation may not offer protection relating to professional liability.

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Lifetime capital gains exemption

Another potential concern is that passive assets held within the same corporation as an active business may preclude a shareholder from claiming the lifetime capital gains exemption ("LCGE") on a potential sale of the business. The LCGE may allow for individual shareholders to avoid tax on a portion of capital gains realized on the sale of shares of certain corporations involved in active business, but not corporations holding too much value in passive assets. Although a corporation, such as a holding company, cannot claim the LCGE, there may be strategies available that allow for excess funds to flow to a holding corporation, "purifying" the active business corporation, while allowing for individual shareholders to access the LCGE.

Individual holding corporations

Holding corporations can also exist in isolation, without an underlying investment in a corporation operating an active business. For example, this could be the case where a corporation has sold its business assets and is left with cash to invest. Where a corporation earns only passive income, the opportunity to defer tax is all but lost, since the tax rate on investment income within a corporation is roughly equal to the rate paid by an individual earning the same income and paying tax at a top marginal rate. Because of a concept called "integration", the aggregate tax paid by the corporation and individual should be roughly the same whether or not the income is paid out to individual shareholders in the form of dividends. That being said, there may be additional reasons to keep investments within a holding company.

Income splitting opportunities

The use of a holding company may allow for potential income splitting opportunities. Where a family unit includes individuals who pay tax at lower marginal rates, this may result in absolute tax savings.

Generally, income splitting is achieved through the introduction of additional individual shareholders. An "estate freeze" can be undertaken to fix the value of shares owned by existing shareholders, and additional shareholders, or, perhaps a family trust, would then subscribe for new shares with a dividend entitlement. This process can involve the use of a separate holding corporation, where it is not desired or it is not possible for the additional shareholders to own shares of an existing corporation directly.

Dividends can be paid to individual shareholders who pay tax personally at lower marginal rates. However, where a private corporation pays dividends to minor children, the dividends will be taxed at the top marginal rate. This tax measure is often referred to as "Kiddie Tax".

U.S estate tax

Canadian resident individuals who own U.S. "situs" property, such as U.S. securities or real property situated in the United States, may be subject to a tax on death based on the fair market value of those assets, even if the Canadian resident is not a citizen or domicilary of the United States. Where the total value of the Canadian resident individual's estate is less than $5.49 million (for 2017), the U.S. estate tax should be effectively avoided, although there may still be an obligation to a US Estate Tax Return in the United States.

For Canadian resident individuals who are subject to U.S. estate tax, the U.S. estate tax may be avoided by holding U.S. situs property through a Canadian holding corporation, since Canadian corporations are not subject to the tax.

Other considerations

Costs of implementation and annual costs

The introduction of a holding company to an existing corporate structure will result in upfront legal and accounting costs, in addition to annual costs of maintaining the structure, such as legal records and tax filings. Such costs should be weighed against the potential tax and non-tax benefits of a holding company.

Shareholder loans and personal use of company assets

Funds held within a holding company are not generally available for use by individual shareholders, until, for example, they are paid to shareholders as dividends.

Where a loan is made to an individual shareholder, it is generally treated as a benefit which is taxable to that shareholder in the year in which the loan is received. An exception exists where the loan is repaid by the shareholder by the second taxation year-end of the corporation, as long as the loan is not part of a "series" of loans and repayments. Similarly, where a holding company invests in an asset such as residential property, any use of the corporate-owned asset by the shareholder may be regarded as a benefit that is taxable to that shareholder.

Double-taxation

On the death of a taxpayer owning shares of a corporation, and the eventual extraction of corporate funds by the estate, the same same corporate value may be taxed two or possibly three times. However, strategies are available to mitigate the amount of tax paid. This is often referred to as "post-mortem tax planning".

Summary

The use of a holding comporation can offer significant benefits. Whether you are considering using a holding corporation to hold a portfolio of investments, or as part of structure including a corporation carrying on an active business, the potential advantages should be weighed against costs and other potential issues.

Speak with your tax advisor to determine if the use of a holding company may be effective for you.

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