Hold the Holdco!
Is a Holding Company Right for You?

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You may be a small business owner. You may own a portfolio of investments. In either scenario, you may be wondering whether a holding company or "Holdco" makes sense for you. There are a number of things to consider before putting a Holdco into place.

What is a Holdco?

Generally, a Holdco itself does not produce goods nor provide services, but exists mainly to hold shares of another company or to hold investments.

Sometimes, a Holdco is a corporation that holds the shares of another company that carries on an operating business. This Holdco is a company that is interposed between the owner and the active business, which may allow profits to be flowed up to, and retained in, the Holdco.

In other cases, a Holdco may be used to own investments, be they a portfolio of marketable securities or some rental properties, rather than owning the investments in your personal name.

What are Some Benefits of Using a Holdco to Own an Operating Company?

There are a number of reasons why you might consider using a Holdco to own operating company ("Opco") shares. These benefits would not be typically available through a one-corporation structure.

Asset Protection

As a business owner, the legal structure by which you hold certain assets (e.g. land, building, vehicles) and conduct business operations can be an important planning consideration. Even in the best run 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 Holdco for certain assets, such as investments, generally means they are not accessible by creditors of the Opco. In some circumstances, it may be beneficial to hold real estate used in a business in a separate Holdco, and have the Opco pay fair market value rent to the Holdco. It's preferable to implement these plans while the business is solvent and there are no pending claims against it. Once a claim has been filed, it may not be possible to move assets out of the operating entity. Consult with a lawyer on asset protection planning.

You may be able to move retained earnings from the Opco by paying tax-free inter-corporate dividends to the Holdco. In some cases, recently enacted tax rules[1] may apply to treat intercorporate dividends paid in excess of retained earnings as a capital gain, so be sure to consult your tax advisor as to the amount of dividends that may safely be paid. The Holdco can then reinvest these dividends in a variety of investments, if desired, including a diversified portfolio of marketable securities.

Should the Opco ever require funds, the Holdco can provide a secured loan by lending the money back to the Opco. Legal documentation should be put in place that permits the Holdco to seize Opco assets to make good on any loans in default. This should give the Holdco lending the money a priority claim to the assets of the Opco, ahead of certain other creditors in the case of Opco's bankruptcy.

Note that there are detailed rules, as well as exceptions, when it comes to the prioritization of security interests, including "super-priority" interests for unpaid wages and income and sales taxes payable. Again, an insolvency lawyer should be consulted before engaging in any type of asset protection strategy involving a Holdco.

Flexibility in Timing

A Holdco can provide flexibility in the timing of dividends paid to shareholders. In some cases, there are multiple shareholders of the Opco, and the shareholders may not always agree on when they want to receive income personally, and thus be responsible to pay personal tax on the dividend income received. For example, one shareholder may not need their dividends to cover personal living expenses in the calendar year they are declared while another shareholder may have a need for current cashflow provided by dividends.

The reason that some shareholders may wish to defer receiving payments from the corporation when they do not otherwise need the funds personally is that by leaving the funds in a corporation, only the corporate tax is paid while the personal tax on the dividend can be deferred, indefinitely, until the dividend is paid out to the shareholder. Since the corporate tax on the business income is generally lower than the personal tax rate, if dividends are deferred to a future year, part of the ultimate tax on the income is deferred until the dividend is paid. In the interim, these additional funds are available to be invested inside the corporation.[2]

If shares in the Opco are held through each shareholder's individual holding company, it may be possible to pay tax-free intercorporate dividends to each Holdco. The shareholders can then decide when to extract the funds from their personal holding companies, at which time they will pay personal tax. Otherwise, funds can be invested within the holding companies, and part of the overall tax can be deferred.[3]

A lawyer must be consulted to make sure the share subscription is properly executed and sufficient funds are paid for the shares. A tax advisor should also be consulted before paying intercorporate dividends to make sure they are not recharacterized for tax purposes as a capital gain, as discussed above.

U.S. Estate Taxes

If U.S. estate taxes are of concern, then holding U.S. investments such as common shares of U.S. corporations in a Holdco may be considered. U.S. estate tax should not apply where U.S. investments are held in a Canadian Holdco, rather than directly by the shareholder. Be sure to speak with a knowledgeable cross border tax advisor before embarking on this strategy.

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1 For more information, see the report titled "Intercorporate Dividends: New Anti-Avoidance Rules" by Debbie Pearl-Weinberg, which is available from your CIBC advisor.

2 Further information on how the tax deferral associated with earning business income works can be found in our reports "The Compensation Conundrum: Will it be salary or dividends?", "Bye-bye Bonus! Why small business owners may prefer dividends over a bonus", and "In Good Company: Retaining investment income in your corporation". These reports are available online in the "Business owners" section at https://www.cibc.com/en/personal-banking/advice-centre/tax-savings-tips.html.

3 While the deferral on active business income can be maintained, there is often a tax prepayment on investment income.

The benefit of future potential U.S. estate tax savings must be balanced with the fact that U.S. dividends received by a Canadian Holdco will be taxed at a higher combined corporate/personal tax rate than if those dividends were received personally and taxed at individual rates, due to a complication of the foreign tax credit system.[4]

Acquiring a Corporation

When an Opco is being acquired, in some cases there may be tax advantages to using a Holdco to make the acquisition, rather than doing so personally. This could be the case both where you have personal funds to invest, and when you are borrowing for the purchase. Other tax benefits may arise through the use of holding companies in an acquisition, including where a non-resident of Canada is involved. As these are complex transactions, legal and tax advisors must be consulted.

Future Sale of a Business

If you are contemplating a future sale of a business, you might consider holding any real estate in a separate Holdco. At times, buyers may only be interested in acquiring core operating business assets. Indeed, some buyers may be more interested in renting the property used to carry on the business rather than owning it and thus would prefer not to acquire the underlying land and/or building associated with the operating business they are purchasing.

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). In 2019, individuals who own shares of a QSBC may be able to claim up to a $866,912[5] capital gains exemption. As it only applies to shares, businesses must be incorporated to qualify. There is no size restriction; however, the company 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 at the time of the sale. 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 on primarily in Canada. Your shares of the corporation cannot have been owned by anyone other than you or a related person (such as your spouse or child) during this 24-month period.

Where a future sale of shares of an Opco is contemplated, but the shares would not satisfy the tests for QSBC status regarding the percentage of assets used in an active business, various "purification" strategies can be used. These strategies reduce the amount of assets held in the corporation that are not used in the active business. One purification method that is sometimes used is to restructure and set up a new Holdco, and transfer excess cash or investments to this Holdco. This, however, is a complex transaction and you should seek professional tax and legal advice if you consider this.

It should also be noted that using a Holdco to own Opco shares before a sale makes claiming the LCGE more complex. The Holdco cannot claim the exemption on the sale of the Opco shares as the LCGE is only available to individuals, not corporations. On the sale of the Holdco shares, while the LCGE may be available, the rules for determining whether the shares qualify as QSBC shares are extremely complex and professional tax advice must be sought.

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[4] Further information on this tax cost can be found in our report "In Good Company: Retaining investment income in your corporation", supra note 2.

[5] For qualified farm and fishing property, the LCGE is $1,000,000.

Further, shares of a Holdco that owns only investment property, rather than shares of an Opco, will not be eligible for the LCGE since the property of this Holdco (being investment property) would not generally be used in an active business.

Estate Freeze

An estate freeze can be implemented in certain circumstances to transfer future growth of a corporation to the next generation. During an estate freeze, a company's share value is "frozen" for the original shareholders (for example, a parent.) Future increases in the fair market value of the company can then accrue solely to the next generation.

In a typical estate freeze, a parent, who is a shareholder, transfers shares in the Opco to a Holdco, and in return, the parent receives fixed value "freeze" shares from the Holdco. In order to have cash for living expenses, the shares may have a dividend payable to the parent, or be redeemed by the parent as needed. Children could then subscribe for common shares of the Holdco at a nominal subscription price. After the exchange, future growth in the value of the Opco shares will accrue to the new common shares.

If the only value received by the parent for the original common shares is the new fixed value preferred shares, no capital gain needs to be triggered. The parent, however, must elect the amount at which the original shares in the Opco are to be exchanged. As this elected amount can be any dollar value between the adjusted cost base ("ACB") of the original shares and their fair market value ("FMV") at the time of the estate freeze, it may also be possible to use the LCGE on an estate freeze. This would be accomplished by electing an amount in excess of the ACB of shares. Similarly, if the parent has unused capital losses, they could elect to transfer the shares at an amount in excess of the ACB, triggering a capital gain that could be offset by the capital losses. If the company is not sold during the parents' lifetime, income taxes payable on the death of the parent are restricted to the value of their frozen interest in the Holdco, as represented in their new, freeze shares. Any capital gains (FMV less ACB) arising on a disposition or deemed disposition (for example, upon death) of the parents' freeze shares will be taxed at the parent's marginal tax rate for capital gains.

Example

Erin is the sole shareholder of her Opco. When Erin originally set up the Opco, she paid only $100 for the shares. The Opco is now worth $2 million. Erin could transfer those shares to a newly incorporated Holdco and receive, in return, preferred shares of Holdco that are redeemable for $2 million. Her adult children could subscribe for common shares in the Holdco. These new common shares would be issued for a nominal amount, perhaps $100, since at that time, the entire value of the Holdco would be reflected in the value of Erin's preferred shares, as they are redeemable at $2 million. If the Opco continues to increase in value, that increase would flow to the common shares in Holdco which are held by Erin's children.

If Erin elects to transfer her common shares to the Holdco for their ACB of $100, then she will not realize a capital gain on the transfer. If, however, Erin wishes to realize a capital gain, because perhaps she has capital losses carried forward, or she wants to make use of the LCGE, she can elect an amount in excess of $100 (up to the $2 million fair market value of the shares being transferred.) For instance, if Erin elects the transfer amount to be $750,100, then she will realize a capital gain of $750,000 [the elected amount of $750,100 less her ACB of $100 of the common shares.]

An estate freeze strategy using a Holdco 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 growing business.

Tax On Split Income (TOSI)

When determining the tax treatment for dividends paid on the common shares issued to the children in an estate freeze, and the tax treatment when those shares are ultimately disposed of, the tax on split income rules ("TOSI") must be considered. In years past, it was common to split income with adult children by paying dividend income from private companies, often after an estate freeze was implemented. This was routinely done through a trust or holding company structure. There were certain anti-avoidance measures in place to limit this income splitting, such as the "kiddie tax," that resulted in certain dividends paid to children under age

18 being taxed at the highest marginal rate in the child's hands. Effective for 2018, however, the kiddie tax rules have been expanded into the more comprehensive TOSI rules so that they apply to more types of income and also cover certain related adults.

The TOSI rules generally apply where an adult receives dividend or interest income from a corporation, or realizes a capital gain on the sale of shares, and a related individual is either actively engaged in the business of the corporation or holds a significant amount of equity (with at least 10% of the value) in the corporation. Where TOSI applies, the income or gain is subject to tax at the highest marginal tax rate. This may severely limit the ability to split income from a Holdco that receives income from an Opco. There are, however, a number of exceptions to the rules.

When the Holdco pays dividends, whether the TOSI rules apply is a complex determination and will depend on the circumstances. For instance, were the dividends paid from funds originating from the dividends received from the Opco? If retained earnings from the business income of the Opco is flowed to the Holdco shareholders, the TOSI rules will likely apply unless the particular shareholder qualifies for an exception to the rules. Were the dividends paid from investment income generated from passive investments within the Holdco itself? In this case, it is likely that the TOSI rules won't apply. Tracing the source of the dividends may be required. There also may be situations where shares of the Opco have been sold. The proceeds were then invested within the Holdco and either income from those investments are paid as dividends, or the proceeds of the sale are paid as dividends from the Holdco. Depending on the circumstances and the length of time between the sale and the dividend payments from the Holdco, it may be possible for dividends to be paid without the TOSI rules applying. External tax advice should be obtained before making any such dividend payments where the TOSI rules are a concern given the complexity of this matter.

When the common shares acquired by the children as a result of an estate freeze are eventually sold, any gain realized should be subject to tax in the those children's names. If the LCGE is available, the gain will not be subject to tax, nor will the TOSI rules apply. If the LCGE is not available, although only 50% of the gain would be subject to tax, the TOSI rules could apply to subject this to tax at the highest marginal tax rate, if another exception to the rules does not apply.

Further information on the TOSI rules and the various exceptions to the rules available can be found in the report titled "The New CCPC Tax Rules."[6]

Should I Incorporate my Investment Portfolio?

We have reviewed the benefits of retaining after-tax business income in a Holdco for investment, but what if investments or funds are already owned personally – is there any tax benefit to transferring those investments to a Holdco and having the investment income earned in the Holdco? In most cases, the answer is no.

In order to understand why, we need to compare the combined tax rate on the investment income earned in the Holdco and the dividend when the after-tax investment income is paid to the shareholder, with the tax rate on investment income when it is earned personally. The results will vary depending on the province or territory in which you (and your Holdco) reside as well as on the type of investment income earned, since different tax rates apply to interest, Canadian dividends and capital gains. Figure 1 indicates whether investing the funds through the Holdco will yield an overall tax savings (or tax cost) compared to earning investment income personally. Based on 2019 combined federal and provincial or territorial tax rates, it's always disadvantageous (or neutral, in the case of Canadian dividends) to have investment income taxed in a Holdco.[7] While Canadian dividends have neutral treatment (if paid out of the Holdco in the same year they are earned[8]), in all other

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6 The report titled "The New CCPC Tax Rules" is available online in the "Business owners" section at https://www.cibc.com/en/personal-banking/advice-centre/tax-savings-tips.html.

7 This assumes that you pay personal tax at the highest marginal tax rate.

8 A refundable Part IV tax $38^1/_3$% is levied on dividends that a Canadian private corporation receives from another, non-connected Canadian corporation. The "Part IV tax" is notionally tracked in the Refundable Dividend Tax on Hand (RDTOH) account and is fully refundable at a rate of $38.33 for every $100 of taxable dividends distributed to the shareholder. Both the after-tax income and refunded tax may be distributed to the shareholder, either as eligible or non-eligible dividends, according to the type of dividends originally earned.

cases there will be a higher combined corporate and personal rate of tax paid by holding investments in a Holdco.

Figure 1: Tax Savings (Cost) from Incorporating Investment Income, by Province or Territory

Jurisdiction	Other Canadian Investment Income	Canadian Dividends	Net Capital Gains
AB	(5.55%)	0.00%	(2.78%)
BC	(5.91%)	0.00%	(2.95%)
MB	(6.94%)	0.00%	(3.47%)
NB	(6.59%)	0.00%	(3.30%)
NL	(7.06%)	0.00%	(3.53%)
NS	(7.98%)	0.00%	(3.99%)
NT	(2.09%)	0.00%	(1.05%)
NU	(5.73%)	0.00%	(2.87%)
ON	(4.12%)	0.00%	(2.06%)
PE	(8.36%)	0.00%	(4.18%)
QC	(3.48%)	0.00%	(1.74%)
SK	(4.80%)	0.00%	(2.40%)
YT	(5.74%)	0.00%	(2.87%)

Source: Tax Templates Inc., July 1, 2019, assuming the shareholder pays tax at the top marginal tax rate

This, however, is not the end of the story. Similar to the taxation of business income discussed under the heading “Flexibility in Timing” above, there may be a tax deferral opportunity to be considered. That is, the rate of tax paid on investment income by the Holdco should be compared to the rate of tax paid by the individual. In some provinces or territories, the tax rate paid within the Holdco is lower than the tax rate paid by the individual. If there is a significant enough difference in these rates of tax, then there may still be a benefit from the tax deferral when earning the income in the Holdco. That is, if the after-tax funds remain in the Holdco where they are reinvested, will this higher amount of after-tax investment income grow to a larger amount than if the investment income was earned personally?

Figure 2 indicates whether there will be tax deferral (or tax prepayment) from investing the funds through the Holdco, compared to earning investment income personally. In most cases, since there is a tax prepayment by earning investment income corporately, combined with the higher tax rates on investment income (in Figure 1 above), it generally doesn’t make sense to incorporate an existing investment portfolio, at least for tax purposes.

Figure 2: Tax Deferral (Prepayment) from Incorporating Investment Income, by Province or Territory

Jurisdiction	Other Canadian Investment Income	Eligible Dividends	Other Than Eligible Dividends	Net Capital Gains
AB	(2.16%)	(6.62%)	3.97%	(1.08%)
BC	(0.87%)	(6.89%)	6.30%	(0.43%)
MB	(0.27%)	(0.55%)	8.34%	(0.13%)
NB	0.63%	(4.82%)	9.42%	0.32%
NL	(2.37%)	4.28%	6.26%	(1.18%)
NS	(0.67%)	3.25%	9.95%	(0.33%)
NT	(3.12%)	(10.00%)	(1.51%)	(1.56%)
NU	(6.17%)	(5.25%)	(0.54%)	(3.08%)
ON	3.36%	1.01%	9.07%	1.68%
PE	(3.30%)	(4.11%)	6.89%	(1.64%)
QC	3.04%	1.67%	7.92%	1.52%
SK	(3.17%)	(8.69%)	2.04%	(1.58%)
YT	(2.67%)	(9.40%)	3.84%	(1.33%)

Source: Tax Templates Inc., July 1, 2019, assuming the shareholder pays tax at the top marginal tax rate

For example, even if Canadian eligible dividends were earned where the overall rate of tax would be the same, whether the dividends are earned personally or through a Holdco, the tax deferral for an Ontario resident would be a mere 1.01% (as shown in Figure 2). In addition, the costs of incorporating and maintaining the Holdco must be taken into account to determine if there is any overall net benefit to holding the investments in a Holdco.

TOSI for Investment Income?

Do the TOSI rules need to be factored into the decision to hold investments through a Holdco? If the Holdco is a pure investment company, with no business carried on, then the TOSI rules should not apply to dividends paid from the Holdco to related parties arising from the investment income. The principal purpose of a business, however, may be to derive income from property, including dividends or interest. Whether or not the Holdco is carrying on a business is determined based on the particular circumstances, and professional advice may be required to make this determination. If a business is carried on, there may be another exception available. For further information, see the report titled "The New CCPC Tax Rules."[9]

[9] Supra, note 6.

Small Business Deduction

Private corporations are generally entitled to a reduced tax rate on the first $500,000 of active business income[10] due to the small business deduction (the "SBD".) This SBD dollar limit must, however, be shared among corporations that are associated[11] for tax purposes. Even if the Holdco itself does not have any active business income, passive income earned within the Holdco may impact access to the SBD for associated corporations.

Effective for the 2019 year, where certain passive investment income is earned in excess of $50,000, it may reduce access to the federal, and in most provinces[12], provincial SBD in the following tax year. For the purpose of this calculation, the passive investment income of associated corporations is pooled. As such, the investment income of a Holdco may impact access to the SBD for an associated Opco. Further information about these rules can be found in the report titled "CCPC Tax Planning for Passive Income."[13] This is yet another consideration to take into account before incorporating an existing investment portfolio.

Conclusion

The decision whether or not to incorporate a Holdco is indeed complicated. There are many instances where a Holdco may be useful. All applicable issues should be fully investigated with both a tax and legal professional. This article contains general information only. Individual situations vary and, accordingly, tax and legal professionals should be consulted.

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[10] This amount is $600,000 for Saskatchewan tax purposes.

[11] The term "associated" is defined in the tax rules. Corporations are associated for tax purposes when they have common control. For instance, if two corporations are owned by the same person, they will be considered associated for tax purposes. Further, in many circumstances, corporations with related shareholders are considered to be associated.

[12] Ontario and New Brunswick have announced that they are not following this federal tax measure.

[13] Our report "CCPC Tax Planning for Passive Income" is available online in the "Business owners" section at https://www.cibc.com/en/personal-banking/advice-centre/tax-savings-tips.html.