Canada Life™

Why set up a holding company?

Many successful business owners will accumulate excess profits and retain them within their corporation. Subsequently establishing a holding company above the operating company may offer the following advantages: creditor protection of retained earnings, allow for different shareholder compensation needs, permit income splitting, and help facilitate an estate freeze.

Creditor protection

In situations where a corporation wants to obtain creditor protection, the use of a holding company to own assets not needed in the operating company's day-to-day operations could be considered. In addition, excess profits (retained earnings) of the operating company can be protected and received by the holding company as tax-efficient inter-corporate dividends. Generally speaking, when the holding company owns more than 10 per cent of the shares of the operating company, dividends may be received tax-free by the holding company under the Income Tax Act (Canada). These earnings and assets are protected from the creditors of the operating company unless the holding company or its shareholders have provided guarantees on behalf of the operating company (to the operating company's lenders, creditors or other suppliers).

Creditor protection depends on court decisions and applicable legislation, which can be subject to change and can vary from each province; they can never be guaranteed. Talk to your lawyer to find out more about the potential for creditor protection specific to your situation.

Equalizing shareholder compensation

If the operating company has multiple owners/managers, each may have different lifestyles and compensation (dividend income) needs. For an owner/manager who prefers the deferral of dividend income that would otherwise be taxed at his/her highest personal marginal tax rate, he/she may instead wish dividends be paid, which if received by a holding company would be received tax free. These funds can then be invested by the holding company, or loaned back to the operating company at an appropriate interest rate. However, any income earned by the holding company would be considered passive income–not eligible for the small business deduction--and subject to the highest corporate tax rates (i.e. combined federal and provincial tax approaching 50 per cent in some provinces). Using money from the holding company to purchase a tax-advantaged permanent life insurance policy can provide tax efficient asset accumulation. As long as the policy's cash value accumulation stays within prescribed limits, the cash value is only subject to income tax when it's withdrawn from the policy. Over the long term the policy's cash value can be accessed in retirement, or the death benefit received by the holding company and distributed as tax-free capital dividends to the estate or successor shareholders can provide for the next generation.

continued

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Estate freeze/income splitting

In simple terms, an estate freeze means transferring the appreciating value of assets (the future growth) to others and locking in the current value and associated income tax to the current owner. This tax liability will be payable when the current owner dies or otherwise disposes of the property, generally preferred shares, he/she received as representing the current value of the private corporation. For owners of a private corporation, often a significant portion of their net worth is represented by the shares of the corporation. An estate freeze may help owners of a Canadian private corporation transfer the future growth of the corporation to other family members (spouse, children or trusts for them) and fix the tax liability on the deemed disposition of their preferred shares upon the owner's death.

A holding company can be used in carrying out an estate freeze. In doing so, the business owner can transfer his/her common shares of the existing operating company to a new holding company and receive, in exchange, preferred shares of the holding company. A family trust might also be part of this planning, and when used, the family trust could subscribe for new common shares of the holding company.

Benefits of an estate freeze include:

- **Tax deferral**: As discussed, an estate freeze helps transfer the future growth of the corporation to the beneficiaries of the family trust (since the trust is the owner of the common shares of the holding company). An estate freeze will fix the value of the property (preferred shares of the holding company) owned by the business owner on death, thereby limiting his/her tax liability on death. In other words, it helps maximize the value of the business owner's estate that will pass to heirs by deferring tax on the growth in the value of the common shares from the date of the freeze, until these common shares are either disposed of by the trust or transferred to the beneficiaries who in turn sell or dispose of the shares. It's important to note, an estate freeze is helpful if the value of the operating company is appreciating or expected to appreciate in the future. An estate freeze may not be beneficial if the value of the corporation declines in future and in fact a reverse freeze (re-freeze) or thaw may have to be considered in such circumstances.

- **Income splitting**: It may be possible to split future income (i.e. have the operating company's after-tax earnings paid to the holding company and then to adult beneficiaries of the family trust), and similarly the potential capital gain on the future sale of shares of the holding company, among the beneficiaries of the trust.

- **Estate tax and estate administration tax (or probate fees)**: Since the value of the operating company's shares currently owned by the business owner become fixed (via preferred shares of the holding company) in an estate freeze, the amount of any estate tax and estate administration tax can be capped (assuming these shares are part of a will to be probated, not applicable in Quebec). It should also be noted that a life insurance policy can provide the necessary money to pay the estate tax and estate administration tax (probate), instead of liquidating certain assets of the estate.

- **Capital gains exemption**: For most capital properties, an amount not less than the adjusted cost base and not more than the fair market value, can be used as the transfer price when implementing the estate freeze under the Income Tax Act. If the business owner's common shares of the operating company are qualified small business corporation (QSBC) shares, a transfer price of the common shares may be used such that a capital gain equal to the unused lifetime capital gains exemption amount of the business owner is triggered. Accordingly, the capital gain realized by the business owner may be offset by the capital gains exemption, resulting in no tax on the gain realized at this time. The transfer price used (adjusted cost base of the original common shares of the operating company plus the capital gain used on the transfer) becomes the adjusted cost base of the exchanged property (i.e. the preferred shares in the holding company) to the business owner. If the accrued gain on business owner's common shares is more than can be offset under his/her capital gains exemption, the additional gain would be taxed upon a later disposition of the preferred shares of the holding company or upon the business owner's death. A higher adjusted cost base in the preferred shares of the holding company helps reduce the capital gain at the business owner's death, and consequently, reduces the final tax liability. With a tax liability that can now be estimated, the business owner (now owning preferred shares) can plan to fund this tax liability with the appropriate amount of life insurance. This strategy also helps preserve the value of his/her estate from erosion due to this tax and the executors (liquidator in Quebec) are not left with having to find money to pay the tax or liquidate assets.

The information provided is based on current tax legislation and interpretations for Canadian residents and is accurate to the best of our knowledge as of the date of publication. Future changes to tax legislation and interpretations may affect this information. This information is general in nature, and is not intended to be legal or tax advice. For specific situations, advice should be obtained from the appropriate professional advisors.

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