



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.

Holding Companies Defined

A holding company is a parent corporation that owns enough voting stock in another company (for example, your business) to control its board of directors, thereby controlling its policies and management. Generally, the holding company itself does not produce goods and services, but exists only to hold shares of another company. 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 regular 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's 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. Income in the operating company may then be subject to a lower tax rate using small business deductions.

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 make good on 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. Referring to the creditor protection strategy above, 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 of the business and 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 dividends to be taxed in their hands, and at their marginal tax rate.

Additional Tax Incentives

Life Insurance Tax Strategy

By using surplus cash in a holding company to purchase any tax-exempt permanent product such as a whole life or universal life insurance policy with the operating company named as the beneficiary, you may be able to accumulate funds sheltered from tax inside the policy. Upon death, proceeds pass tax-free to the operating company and increase its capital dividend account. This can provide an opportunity for tax-free dividends to be passed on to your estate or heirs.

U.S. Estate Taxes

A Canadian holding company can be used to hold U.S. investments to shelter a Canadian resident shareholder from U.S. estate taxes. The holding company must be a genuine Canadian investment holding company. However, as this is a complex strategy, it should only be considered with the advice of a professional international tax consultant.

Considerations

Capital Gains Exemption

The capital gains exemption for qualifying small business corporations (QSBC) can be claimed to offset a capital gain on the sale of shares. Each family member of qualified small businesses may also be eligible for a \$750,000 capital gains exemption. 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). There are two tests to pass for an operating company to qualify as a QSBC. These tests are applied differently when a holding company is used. The first is the determination time test – at the time the shares are sold, 90 percent of the fair value of the assets must be used to generate active business income. The second test is the holding period test. In the 24 months preceding the sale, more than 50 percent of the fair value of the assets must have been used to generate active business income. This test is applied on a day-to-day basis throughout the 24-month period.

When a holding company is used, the second test is applied differently. When calculating whether a holding company is a QSBC, the shares of the operating company that it owns will only be viewed as being used in an active business if the operating company meets the first test, not the second test. In other words, as soon as a holding company is opened, the shares in the original operating company are treated as investment assets to the holding company, and not assets used in an active business, unless no more than 10 percent of the operating company's assets are investment assets during the 24 months prior to sale. If a business owner wants to claim the capital gains deduction on a sale, the surplus investments from the operating company must be removed (a process called purification) and then two years must pass before the sale of the business. This is a complex process for which professional tax advice must be sought.

Estate Freeze

An estate freeze can be implemented to reduce the amount of taxes that are payable on the transfer of assets to a beneficiary. "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 pass to the next generation. A parent transfers his/her shares in the operating company to a holding company, and in return, the parent receives fixed value "freeze" shares from the holding company. An estate freeze may proceed under section 85 of the Income Tax Act. A holding company may be used for an estate freeze from start up, however, the estate freeze structure is more commonly implemented, and a holding company set up, once the business has become more established.

Children then subscribe to common shares of the holding company at a nominal subscription price. After the exchange, future growth in the value of the shares will accrue to the new common shares. If the only value received for the original shares is the new growth shares, capital gains will not be triggered. Additionally, if the parent has capital losses, he/she 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.

Sale Of The Company

If the operating company is sold, the common shares held by the children will be taxed in their hands, resulting in tax savings if the children are in a lower tax bracket than the parents. If the company is not sold during the parents' lifetime, income tax and probate fees (not applicable in Quebec) are restricted to the value of the frozen interest in the company. Any capital gains (fair market value, less original 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. Please consult a tax professional to determine if an estate freeze strategy can be applied to your growing business.

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

This article contains general information only. Individual situations vary and, accordingly, tax and legal professionals should be consulted.

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