Maximize Charitable Giving using a Holding Company

A small business can be an extraordinary opportunity for creating wealth. Small businesses are also the biggest creator of jobs in Canada. Almost 60% of Canada's small and mid-sized business owners are aged 50 or older, nearly double the proportion of the overall workforce, indicated in a 2017 BDC study on ***The Coming Wave of Business Transitions in Canada***. Furthermore, according to the Canadian Federation of Independent Business (CFIB), approximately 50% of business owners plan on exiting their business in the next five years with more than 75% planning to exit within the next 10 years. This provides a great opportunity for effective tax planning and charitable gift planning strategies for business owners.

Our tax rules provide a favourable tax rate for small businesses structured as Canadian-controlled private corporations (CCPC). Specifically, the first $500,000 (known as the small business limit) per year of qualifying active business income of a CCPC enjoys a very low federal small business corporate income tax rate of 9%, compared to the general business income tax rate of 15%.[1]

Locked-up Capital in Holding Companies

Business owners set up holding companies for many reasons, many of which include the potential ability to protect themselves from claims of creditors or as a retirement strategy deferring personal income taxes by investing higher after-tax corporate business income in an investment portfolio inside the corporation versus withdrawing the corporate funds personally and investing a lower amount of after-tax personal capital.[2] The cash accumulated inside an operating company can be transferred to a holding company via inter-corporate dividends, generally on a tax-free basis, to achieve these above two goals. While the low tax rate for small businesses helps spur growth in the business sector and helps the business owners accumulate wealth, this wealth creates complexity.

A common dilemma for many business owners is how to extract the funds in their corporations and holding companies without paying high personal income taxes when those funds are ultimately distributed to the individual business owner as taxable dividend income. There can be substantial reduction in the value of accumulated capital upon withdrawal of the funds. For example, assuming a combined federal and provincial personal dividend tax rate of 45%, a holding company with a value of $3,000,000, is actually only worth $1,650,000 after personal tax. Therefore, it is understandable that business owners are always seeking tax effective methods of extracting their 'locked-up' capital from their corporations. The following discussion considers how charitable giving can help business owners achieve a greater level of giving while also realizing corporate and personal tax benefits.

Charitable Giving Considerations

When a corporation makes a charitable gift, the corporation may claim a tax deduction for the fair market value of the gift, which results in a reduction of the income earned by the corporation. When a charitable gift is made personally, it results in a charitable donation tax credit which will reduce the personal tax that was otherwise payable. For both personal and corporate donations, the maximum amount of the charitable donations that may be claimed in a given year is limited to 75%[3] of net income and if the credit or deduction cannot be claimed, it can be carried forward for up to 5 years.

It is worth noting that in an effort to increase charitable donations, the tax laws allow for the full elimination of any capital gains tax on donations of qualifying publicly-traded securities for both donations made personally or by a corporation, as addressed in further detail below.

The Benefits of Giving Though a Private Corporation

Private corporations have a notional tax account, known as a capital dividend account (CDA). A powerful tax tool, this notional account, when positive, may be paid to shareholders on a tax-free basis, which could facilitate the tax-efficient withdrawal of funds form the company to its individual shareholders. The cumulative CDA balance does not appear on a corporation's balance sheet, but is rather maintained by the corporation's tax working papers and tracked in the corporation's tax return.

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The CDA balance also creates a unique financial planning opportunity for business owners when it comes to philanthropic tax planning and can make charitable giving through a corporation extremely attractive.

When a publicly-traded security is sold by a corporation, 50% of the resulting capital gain is taxable as income and the remaining (50%) non-taxable portion is credited to the corporation's CDA account. Alternatively, by donating the securities (other than flow-through shares) with accrued gains directly in-kind to a charity, there is an opportunity to reduce the tax that would otherwise have to be payable on the sale of the investments. Although a donation of securities is considered a disposition for tax purposes, tax incentives allow for the taxable capital gain realized on a donated publicly-traded security to be eliminated – i.e. the 50% taxable portion is eliminated and therefore the full capital gain is exempted from tax. In addition, for a CCPC that donates a qualifying publicly-traded security, the full 100% non-taxable portion of the gain will be added to its CDA balance, providing the ability to extract an increased level of funds out of the corporation to its shareholders tax-free.

The decision to make a charitable gift is a personal decision and is based on the philanthropic intentions of the donor. Often, the decision as to whether to make a gift personally or through a corporation hinges on the tax benefits that can be realized. Therefore, the ability to extract money on a tax-free basis from a corporation through the CDA, is a major consideration for shareholders as to where the source of funds for the charitable gift should be.[4]

Consulting with a tax advisor to explore the various charitable giving options available to business owners is the next best step to ensure that philanthropic goals can be achieved in a meaningful and tax efficient way.

The story of how one client used appreciated securities from a holding company to create a private foundation

Mr. V., who came from a humble background, was the first in his family to attend university. He went on to become a very successful businessman, and a developer of large office buildings.

In his own words, he has always been a 'giver' rather than a 'taker' as evidenced by his generous support of a local hospital and some universities in his province. With this in mind, his banker suggested that he might prefer to create a private foundation which would allow him to enjoy his philanthropy in a more measured and impactful way.

After meeting with a member of BMO's Philanthropic Advisory Services team, Mr. V. decided that a private foundation was the right vehicle to meet his long term philanthropic goals. He was impressed by how easily and quickly a foundation could be created and, typical of most entrepreneurs, he liked the idea of having control over the management of the assets and making annual grants to charities.

Within one month of Mr. V. deciding to proceed, his foundation was incorporated as a non-profit organization and registered as a charity with CRA.

Mr. V. donated publicly-traded shares in his holding company to the foundation with a cost of approximately $700,000 and market value of $2.2 million. The corporation received a tax receipt for the market value of the shares to claim a charitable deduction against its taxable income. In addition, the corporation avoided the capital gains tax that would have otherwise been payable on the $1.5 million gain and also increased its CDA balance by $1.5 million at that time.

In the meantime, BMO's Philanthropic advisor worked with Mr. V and his family members to identify their values, aspirations and charitable interests, culminating in the creation of a mission statement. A granting strategy was developed to enable the foundation to meet its goal of supporting outstanding university programs.

At the end of the day, Mr. V was pleased with the strategy that was put in place to minimize taxes and achieve his goal of leaving a charitable legacy.

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[1] The federal small business limit of $500,000 is shared among associated companies and is clawed back when the associated group of companies has taxable capital in excess of $10 million and completely eliminated with taxable capital in excess of $15 million.

[2] New tax measures enacted in 2018 further provide for a claw back to the $500,000 small business limit for CCPCs that earn significant passive investment income. Specifically, if a CCPC (and its associated corporations) earn more than $50,000 of passive investment income in a given year, the amount of income eligible for the small business tax rate (i.e. the small business limit) will be reduced and completely eliminated at $150,000 of passive investment income.

[3] Changes originating from the 2016 Quebec Budget have removed the 75% limitation for 2016 and subsequent taxation years in calculating the qualifying Quebec provincial donation tax credit. In addition, favourable new terms for calculating the tax credit for Quebec tax purposes were introduced beginning for the 2017 taxation year.

[4] For further information and tax benefit considerations, please refer to our publication **Donating Appreciated Securities**.

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