Understanding Personal Holding Companies

Many individuals hold investment portfolios in a personal holding company. It is important for these investors to understand the various tax implications of earning investment income through a holding company. Tax considerations can be quite different from owning investments personally, because a corporate structure introduces a number of other considerations.

This article is designed to briefly outline some of the significant Canadian tax implications for a Canadian resident individual owning investment assets and earning investment income through a Canadian-controlled private corporation (CCPC); including various tax planning techniques and tax pitfalls associated with personal holding companies.

What is a Personal Holding Company

A personal holding company (PHC) is often referred to as a "Holdco" or "Investment Holding Company". A PHC is not a defined term in the Income Tax Act, but rather a term adopted to define a corporation which holds assets; typically income-generating investment assets. A PHC is usually a CCPC and is a separate legal entity from its owners, requiring financial statements and separate filing of corporate tax returns. Quite often, individual family members (or a family trust) will hold the various common and preferred shares of the private corporation, which owns the underlying investment securities.

Uses for Personal Holding Companies

Existing Business Owners – It's quite common for business owners to set up a PHC to hold the shares of an operating company and/or to protect investment assets that are not needed in the company's business. An important planning tool involves the receipt of an inter-corporate dividend by a (parent) holding company from a (subsidiary) operating company, which is "connected" or controlled by it. In many instances, these inter-corporate dividends can be received tax-free.

Former Business Owners – A PHC often results after the sale of business assets by an operating company. The proceeds from the sale are kept in the corporation (to defer possible personal tax upon a wind-up or distribution) and are used to purchase investment securities.

Estate Freeze / Income Splitting – A PHC can be used to facilitate the transfer of wealth to the next generation and assist with succession planning. Appreciating assets, such as shares of an operating company or an investment portfolio, can be transferred to the next generation through a PHC in the context of an estate freeze. An estate freeze caps an individual's tax liability at their death and transfers any future growth to younger family members. The ability to split income amongst family members, subject to various income attribution rules, can also be facilitated through a PHC.

U.S. Estate Tax Planning – Traditionally, PHCs have been used to hold U.S. real estate or U.S. investment assets as a means of avoiding U.S. estate tax. Changes to the Canada Revenue Agency's (CRA) administrative position several years ago, regarding Single-Purpose Corporations, have curtailed the use of PHCs to hold personal-use U.S. real estate (unless they are grandfathered under the former policy); however, PHCs can still be effective for holding U.S. securities. Please see our other publications on U.S. estate tax entitled, *U.S. Estate Tax for Canadians* and *Tax and Estate Consequences of Investing in U.S. Securities,* or consult with your tax advisor for further information on this topic.

Incorporated Professionals – Many professionals, including doctors, lawyers and accountants, incorporate their practices for tax deferral opportunities and other benefits of incorporation. Where allowable, they may use PHCs as part of this structure to hold any assets not needed for use directly in their practice.

Other Non-Tax Reasons – There may be other non-tax benefits of using a corporate structure, such as limited liability protection, creditor protection, confidentiality or the indefinite continuity offered by a corporation. In some provinces, PHCs can pass under a separate Will to reduce probate tax.

Disadvantages

Notwithstanding the possible tax and other benefits of a corporate structure, a corporation introduces additional complexity and requires additional set-up and ongoing costs; such as costs to prepare annual financial statements, corporate tax returns and maintain corporate registers. Any losses realized in a corporation are only available to offset other income earned by the business. Finally, because a PHC introduces an additional level of tax (i.e., corporate tax on the income earned by the PHC), in addition to any personal income tax on distributions from the PHC, double-taxation of the underlying income may result. This is an important consideration and is discussed in more detail in the *Potential Double Taxation* section of this report.

Although it is generally possible to transfer assets to a corporation on a tax-deferred, rollover basis (in exchange for shares of the corporation), the wind-up or distribution of corporate assets to the shareholder(s) is more complicated and may entail both corporate and personal tax costs.

Canadian Investment Income - Corporate Versus Personal Tax Rates - 2014

Province	Income Type	CCPC Corporate Tax Rates %	Top Marginal Personal Tax Rates
Alberta	Interest	44.67	39.00
	Eligible Dividends	33.33	19.29
	Capital Gains	22.34	19.50
B.C.	Interest	45.67	45.80
	Eligible Dividends	33.33	28.68
	Capital Gains	22.84	22.90
Manitoba	Interest	46.67	46.40
	Eligible Dividends	33.33	32.26
	Capital Gains	23.34	23.20
N.B	Interest	46.67	46.84
	Eligible Dividends	33.33	27.35
	Capital Gains	23.34	23.42
Nfld.	Interest	48.67	42.30
	Eligible Dividends	33.33	22.47
	Capital Gains	24.34	21.15
N.W.T	Interest	46.17	43.05
	Eligible Dividends	33.33	22.81
	Capital Gains	23.09	21.53
N.S.	Interest	50.67	50.00
	Eligible Dividends	33.33	36.06
	Capital Gains	25.34	25.00
Nunavut	Interest	46.67	40.50
	Eligible Dividends	33.33	27.56
	Capital Gains	23.34	20.25
Ontario	Interest	46.17	46.41 (1)
	Eligible Dividends	33.33	29.52 (1)
	Capital Gains	23.08	23.21 (1)
P.E.I	Interest	50.67	47.37
	Eligible Dividends	33.33	28.70
	Capital Gains	25.34	23.69
Quebec	Interest	46.57	49.97
	Eligible Dividends	33.33	35.22
	Capital Gains	23.29	24.98
Sask.	Interest	46.67	44.00
	Eligible Dividends	33.33	24.81
	Capital Gains	23.34	22.00
Yukon	Interest	49.67	42.40
	Eligible Dividends	33.33	15.93 to 19.29
	Capital Gains	24.84	21.20

*Includes both federal and provincial rates, as of November 2013.

(1) The Ontario government's 2012 budget introduced an additional surtax on high taxable incomes which took effect July 1, 2012, but is scheduled to be eliminated once the budget is balanced (expected to be in 2017/2018). The impact of this 2% surtax in 2014 on personal taxable incomes exceeding $509,000 (to be indexed from 2013) is as follows:

Top Marginal Tax Rate		
Salary & Interest	Capital Gains	Eligible Dividends
49.53%	24.77%	33.82%

Taxation of Investment Income in PHCs

The investment income earned on assets in a PHC is taxed in the corporation, which must file an annual corporate income tax return. Many people still believe that they will save taxes by holding their investment securities in a PHC, as opposed to holding them personally. In the early 1990s, the personal marginal tax rates in many provinces were considerably higher than corporate income tax rates. Therefore, high income individuals who had significant investment assets, and did not need the annual income, could save taxes by moving the assets to a PHC.

This all changed in the mid-1990s when corporate tax rates rose and personal tax rates began to fall. The preceding table entitled *Canadian Investment Income - Corporate Versus Personal Tax Rates,* shows the 2014 corporate and personal tax rates on investment income for all provinces and territories. As you can see, the corporate tax rates are higher than the personal tax rates for all investment income with the exception of Quebec; interest and capital gain income earned in Ontario, British Columbia and New Brunswick; and eligible dividends earned in Nova Scotia. Accordingly, the deferral benefit formerly associated with earning investment income through a holding company no longer exists in most provinces and territories.

Integration

However, the concept of integration within Canadian tax legislation for CCPCs seeks to make an individual indifferent between earning investment income personally, or indirectly through a PHC. This is a concern since an individual earning investment income directly pays only one level of taxation, whereas someone earning investment income through a corporation will pay tax at two levels (i.e., corporate tax on the investment income earned in the corporation and personal tax on the distribution of the after-tax income to the individual shareholder; which is typically received as a dividend). Integration attempts to equalize the ultimate tax paid in either scenario. Through the use of various corporate tax accounts, such as the Capital Dividend Account (CDA) and Refundable Dividend Tax on Hand (RDTOH), as well as other tax mechanisms (e.g. dividend tax credit, and dividend refund), distributions from a PHC may result in a refund of corporate tax previously paid and/or will be subject to a reduced personal rate of taxation as partial compensation for this high initial corporate tax paid. This integration methodology seeks to equalize the aggregate amount of corporate and personal tax paid in a PHC structure, with the level of tax paid for investment income earned personally that is subject to only one level of taxation.

However, the integration system is imperfect and may break down such that a pre-payment of tax or a tax cost from double-taxation may result; particularly on higher-taxed investment income. As a result of the higher 2014 tax rates on ineligible dividend income, the tax cost of earning investment income through a PHC has increased for 2014. Depending on the relevant provincial personal and corporate tax rates, this tax cost is generally 3 - 4 percent on interest income, but ranges as high as 6 percent (PEI and Manitoba) and may be significant on foreign investment income that is also subject to foreign withholding tax at source.

Shareholder Taxable Benefits

A common problem with the PHC structure is that an individual often treats the assets owned by the PHC that they control in the same manner as assets

held personally. The shareholder fails to appreciate that assets within a PHC are owned by the PHC since it is a separate legal entity; and their entitlements as a shareholder are governed by the terms of the class of shares of the PHC they own.

There are potential negative tax ramifications for the use of corporate property by a shareholder, such as the personal use of real estate owned by a corporation. Potentially more problematic is the use of corporate funds to pay personal expenses, or the creation of shareholder loans from the PHC to the shareholder(s) (or related persons). The existence of such loans can deem the individual shareholder to have received a taxable benefit in the form of an imputed interest benefit (at the CRA's prescribed interest rates) during the period the loan remains outstanding, or the possible inclusion in the shareholder's income of the amount of the loan itself; to the extent it remains unpaid by the individual (or is repaid and subsequently readvanced).

Distributions from a PHC

In order to avoid the negative tax implications associated with a loan of corporate funds to a shareholder, the PHC should consider more tax-efficient ways of distributing funds to its shareholders for personal use. For example, the following mechanisms could be used to distribute funds from a PHC with minimal or no tax consequences:

Repayment of Shareholder Loan

A loan to the PHC from a shareholder can be returned to the shareholder without tax consequences, since the loan was originally contributed to the corporation out of the shareholder's after-tax funds.

Paid-Up Capital Reduction

Paid-Up Capital (PUC) generally represents an amount originally contributed by the shareholder for the shares of the PHC they own. It is calculated separately for each class of shares issued.

Because these amounts were originally contributed out of the shareholder's after-tax funds, the tax PUC can generally be returned tax-free on a PUC reduction or share redemption.

Capital Dividend Account (CDA)

The CDA represents the cumulative non-taxable portion of net capital gains/losses and certain other amounts (such as life insurance proceeds) received by a corporation. It is an important component of tax integration.

Distribution of the CDA allows for the tax-free flow-through of certain amounts that would be non-taxable if the shareholder had received them directly.

Since CDA represents the cumulative balance at a point in time, it is generally beneficial to distribute whenever a significant positive balance exists.

Taxable Dividends

The payment of a taxable dividend by a PHC to its shareholder(s) may cause a refund of corporate tax to the PHC accumulated in the RDTOH notional tax account. This *dividend refund* could exceed the personal tax payable by the individual on the dividend, especially in light of the lower personal tax rates for eligible dividends. However, in many provinces the personal tax payable on ineligible dividends to a top tax bracket individual will exceed the dividend refund to the corporation, especially in light of the higher tax rates on ineligible dividends beginning in 2014. See our publication entitled *Eligible Dividends,* for more information on the current dividend tax rates.

Insurance Strategy

Often a PHC holds a significant balance of cash, particularly following the sale of business assets. If it is likely that the shareholder has no need or intention of accessing these funds during their lifetime, such that the PHC assets will form part of their estate, a possible insurance strategy may exist. Briefly stated, this strategy involves the purchase of permanent life insurance with corporate funds to take advantage of the tax-deferred growth of the insurance, and potential use of a capital dividend account in the PHC at death to facilitate a tax-efficient distribution of the corporate assets to heirs.

For more information, please ask your Investment Advisor for a copy of the BMO Nesbitt Burns publication entitled, *Tax-Free Dividend with Life Insurance,* and speak to your tax advisor to discuss the potential application of this strategy to your personal situation.

The distribution of the preceding tax balances and any tax planning undertaken to access funds from a PHC is complex and will require the assistance of a tax advisor to understand the tax implications to the PHC and its shareholders.

Potential Double-Taxation

As outlined previously, the use of a PHC creates the potential for double-taxation, by introducing a second level of (corporate) taxation. This is of particular concern when an individual dies owning shares of a PHC, and his/her heirs are more likely to sell the underlying assets owned within the PHC and wind-up the PHC, rather than selling the shares of the PHC directly to a third party after death. A simplified example can best illustrate this double-taxation issue:

Assume:

- Mr. Smith owns an investment portfolio with a tax cost base of $100,000 and a current value of $1,000,000.
- Mr. Smith transfers the securities to Smith Co. on a tax-deferred basis in exchange for common shares of Smith Co., which have a value of $1,000,000. His (outside) tax cost of the shares in Smith Co. will be $100,000. Similarly, Smith Co. will inherit Mr . Smith's cost base of the investment portfolio of $100,000 (i.e., the inside cost base).
- Mr. Smith dies and the shares of Smith Co. are transferred to his children pursuant to the terms of his Will. Assume that no appreciation has occurred in the investment portfolio since the PHC was established, such that the current market value of the securities remains at $1,000,000.

Result:

- Mr. Smith realizes a capital gain at death on his shares of Smith Co. of $900,000 (i.e., $1,000,000 assumed value less his $100,000 outside tax cost). However, Mr. Smith's death has no impact on the (inside) cost to Smith Co. of its underlying investment portfolio, such that when Smith Co. sells these securities, it will realize a similar capital gain corporately of $900,000 (i.e., $1,000,000 value less its $100,000 inside tax cost), which creates double taxation of the same gain.

Various post-mortem tax strategies exist to reduce or eliminate this double-taxation, but it's important to be aware of this issue and incorporate an appropriate strategy into an estate plan whenever shares of a PHC may be held at death. Some common strategies used are time sensitive, so the executors of an estate containing shares of a PHC should be particularly careful to seek appropriate and timely advice in administering the estate to ensure tax minimization for the estate and its beneficiaries.

Summary

Owning an investment portfolio through a personal holding company can provide various tax and non-tax benefits, but can also introduce many other tax considerations that are not applicable when investments are held personally. In particular, care should be taken in establishing a personal holding company, accessing or distributing funds from a PHC for personal use, and in the development of an estate plan for a shareholder of a PHC.

The taxation of holding corporations is complex and the commentary provided herein is only of a general nature. Please consult with your tax advisor for more information and assistance in your particular situation.

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