# Understanding Personal Holding Companies

Many individuals hold investment portfolios in a personal holding company. It`s important for these investors to understand the various tax implications of earning investment income through a holding company; particularly in light of the recent tax changes affecting private corporations. Tax implications 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"). Common tax planning techniques are highlighted, including the impact of the recent tax changes affecting private corporations, and various tax pitfalls associated with personal holding companies.

## Personal Holding Company Defined

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 the holding company. In many instances, these inter-corporate dividends can be received tax-free. However, a specific provision in the tax law could cause some inter-corporate tax-free dividends involved in common tax planning situations to be re-characterized as a taxable capital gain. Therefore, be sure to consult with your tax advisor when contemplating the payment of any inter-corporate dividends.

**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. The former business owner can then extract funds as required in the most tax efficient manner possible, to fund their lifestyle requirements.

**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 and transfers any future growth to younger family members. The ability to split income amongst family members, subject to the recent enhancements to the tax on split income ("TOSI") and 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 for U.S. estate tax purposes, subject to potentially higher tax costs of earning foreign investment income corporately.



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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. Please see our BMO Wealth Management publication entitled **Is a professional corporation right for you?** for more information on this topic.

**Other Non-Tax Reasons** – There may be other non-taxbenefits 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.

## Impact of Recent Tax Changes Affecting Private Corporations

The Federal government has recently amended the tax legislation to address a number of its concerns regarding tax planning strategies involving private corporations. This amended legislation seeks to target certain strategies which can result in high income individuals gaining perceived tax advantages through a variety of tax reduction strategies involving private companies that are not available to other Canadians. Strategies involving private corporations specifically identified by the government include:

**Income splitting,** which can reduce income taxes by causing income (such as dividends and capital gains) that would otherwise be realized by an individual facing a high personal income tax rate to instead be realized by family members who are subject to lower personal tax rates. Prior to the recent expansion of the "tax on split income" or "TOSI" rules, effective for the 2018 and subsequent taxation years, private companies were often used to facilitate income splitting with family members. The strategy involves structuring a spouse, children or other family members as shareholders of the private company; either directly or indirectly through a family trust. Dividends could then be paid to family members who were 18 years of age or older and taxed at their lower tax rates, thus potentially reducing the family's overall tax bill.

However, effective January 1, 2018, any shareholder of a corporation who does not meet specific exceptions will now be subject to the expanded TOSI rules which will apply the highest marginal tax rate to income, including dividends, paid to them directly or through a family trust. Please see our BMO Wealth Management publication, **Tax Changes Affecting Private Corporations: Tax on Split Income (TOSI)** for more information on this topic.

***Holding passive investments inside a private corporation;*** Two recently-enacted tax measures originating from the 2018 Federal Budget may impact private companies that earn active business income either directly or through an associated corporation.

By way of background, qualifying active business income earned by a CCPC can benefit from a reduced corporate tax rate by utilizing the small business deduction ("SBD"). The lower tax rate is designed to allow small businesses to retain additional cash in the corporation to re-invest in the active business. For example, the 2020 corporate income tax rate in Alberta on the first $500,000 of earnings eligible for the small business deduction is 11 per cent, whereas active business income not eligible for the SBD is taxed at 23 per cent (after June 30, 2020). Conversely, investment income, including most rental income, is considered passive income and is subject to higher corporate tax rates, as discussed in a subsequent section.

The first measure enacted will claw back the Federal SBD (available on the first $500,000 of active business income) by $5 for every $1 of passive investment income above a $50,000 threshold. Accordingly, at $150,000 of investment income, a corporation would no longer qualify for the small business deduction, and therefore would pay a higher general corporate tax rate. This rule will also apply to any associated corporations; in essence any organization – or group of companies – with **both** active and passive sources of income.

The second recently-enacted measure seeks to limit access to a perceived tax advantage that arose under the previous tax law when an eligible dividend is paid and refundable tax is recovered by the corporation. As described subsequently, corporate tax on passive investment income earned is taxed at a rate that approximates the highest marginal personal income tax rate. A portion of this tax is refundable to the corporation when a taxable dividend is paid to a shareholder. Previously, a corporation received a refund of tax paid on investment income even when a lower-taxed (eligible) dividend, sourced from active income taxed at the (lower) general corporate rate, was paid. Changes originating from the 2018 Federal Budget will now ensure that a refund of the refundable tax is available only where a corporation pays a higher-taxed (non-eligible) dividend, except upon the payment of an eligible dividend where the refundable tax was sourced from the receipt of an eligible portfolio dividend.

## 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.

## 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. Given that corporate tax rates are generally lower than personal tax rates, special refundable taxes are imposed on the investment income of private corporations in order to limit the ability of individuals to defer taxation by holding investments in a private corporation. However, in light of the 4 percent increase in the top Federal personal tax rate several years ago, the "integration" tax system for private corporations (described below), which seeks to ensure consistency in taxation between individuals earning investment income personally or through a private company, was amended to ensure its effectiveness with this increased top personal tax rate. In particular, increases were enacted to the (refundable) corporate tax rates on investment income and the rate at which corporate taxes are refunded from taxable dividend payments, effective January 1, 2016.†

The following table, Canadian Investment Income – Corporate Versus Personal Tax Rates compares the 2020 corporate and personal tax rates on investment income for all provinces and territories. As you can see, the corporate tax rates in many jurisdictions are higher than the personal tax rates for investment income. Accordingly, the deferral benefit associated with earning investment income through a holding company does not exist in these provinces and territories.

### Canadian Investment Income
**Corporate Versus Personal Tax Rates – 2020[1]**

| Province | Income Type | CCPC Corporate Tax Rates % | Top Marginal Personal Tax Rates %[2] |
|---|---|---|---|
| **Alberta** | Interest<br>Eligible Dividends<br>Capital Gains | 48.67[3]<br>38.33<br>23.34[3] | 48.00<br>31.71<br>24.00 |
| **British Columbia** | Interest<br>Eligible Dividends<br>Capital Gains | 50.67<br>38.33<br>25.34 | 53.50<br>36.54<br>26.75 |
| **Manitoba** | Interest<br>Eligible Dividends<br>Capital Gains | 50.67<br>38.33<br>25.34 | 50.40<br>37.78<br>25.20 |
| **New Brunswick** | Interest<br>Eligible Dividends<br>Capital Gains | 52.67<br>38.33<br>26.34 | 53.30<br>33.51<br>26.65 |
| **Newfoundland** | Interest<br>Eligible Dividends<br>Capital Gains | 53.67<br>38.33<br>26.84 | 51.30<br>42.61<br>25.65 |
| **Northwest Territories** | Interest<br>Eligible Dividends<br>Capital Gains | 50.17<br>38.33<br>25.09 | 47.05<br>28.33<br>23.53 |
| **Nova Scotia** | Interest<br>Eligible Dividends<br>Capital Gains | 54.67[4]<br>38.33<br>27.34[4] | 54.00<br>41.58<br>27.00 |
| **Nunavut** | Interest<br>Eligible Dividends<br>Capital Gains | 50.67<br>38.33<br>25.34 | 44.50<br>33.08<br>22.25 |
| **Ontario** | Interest<br>Eligible Dividends<br>Capital Gains | 50.17<br>38.33<br>25.09 | 53.53<br>39.34<br>26.77 |
| **Prince Edward Island** | Interest<br>Eligible Dividends<br>Capital Gains | 54.67<br>38.33<br>27.34 | 51.37<br>34.22<br>25.69 |
| **Quebec** | Interest<br>Eligible Dividends<br>Capital Gains | 50.17<br>38.33<br>25.09 | 53.31<br>40.11<br>26.66 |
| **Saskatchewan** | Interest<br>Eligible Dividends<br>Capital Gains | 50.67<br>38.33<br>25.34 | 47.50<br>29.64<br>23.75 |
| **Yukon** | Interest<br>Eligible Dividends<br>Capital Gains | 50.67<br>38.33<br>25.34 | 48.00<br>28.93<br>24.00 |

[1] Combines both federal and provincial rates.
[2] Reflects the 2020 top combined individual marginal tax rates by province, as of June 2020. The rates apply to taxable incomes over $214,368 except that the thresholds are $220,000 in Ontario and British Columbia, $314,928 in Alberta and $500,000 in Yukon.
[3] As of July 1, 2020
[4] As of April 1, 2020

**Integration** – The concept of integration within the 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 amount 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 increased tax rates, there is a tax cost of earning interest and capital gain investment income through a PHC for 2020 in all provinces and territories. Depending on the relevant provincial personal and corporate tax rates, this tax cost is generally 4 to 7 per cent on interest income, and may be even higher 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 held 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 balance of 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 (and prior to the realization of any accrued capital losses).

**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 Refundable Dividend Tax on Hand notional tax account. However, in light of the tax changes outlined previously, which will generally restrict the refund of RDTOH to the payment of ineligible dividends, the personal tax payable on these dividends to a top tax bracket individual will often exceed the dividend refund to the corporation, thereby reducing the efficiency of this strategy.

**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. Further benefits may arise from this strategy for any corporations potentially subject to the clawback of the small business deduction resulting from the recent tax changes previously outlined.

For more information, please ask your BMO financial professional for a copy of the publication **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 specific 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). When Mr. Smith dies, 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 critical 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. In addition, individuals owning a personal holding company, or those considering establishing one, should be aware of the potential impact of the recent tax changes affecting private corporations.

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**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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† The refundable taxes and related dividend refund rate was increased effective January 1, 2016 to reflect the new 33-per-cent federal top personal income tax rate. Specifically:

- the refundable additional Part I tax on investment income of Canadian-controlled private corporations (CCPCs) was increased by 4 percentage points (to 10.67 per cent from 6.67 percent);
- the refundable portion of Part I tax on investment income of CCPCs was increased by 4 percentage points (to 30.67 per cent from 26.67 per cent);
- the refundable Part IV tax on portfolio dividends received by private corporations was increased by 5 percentage points (to 38.33 per cent from 33.33 per cent); and
- the rate at which refunds are made out of a private corporation's pool of refundable taxes previously paid (known as "Refundable Dividend Tax on Hand") when it pays dividends was increased by 5 percentage points (to 38.33 per cent from 33.33 per cent of dividends paid).



20-0983 ID0612