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Taxation of Investment Holding Companies (IHC's)

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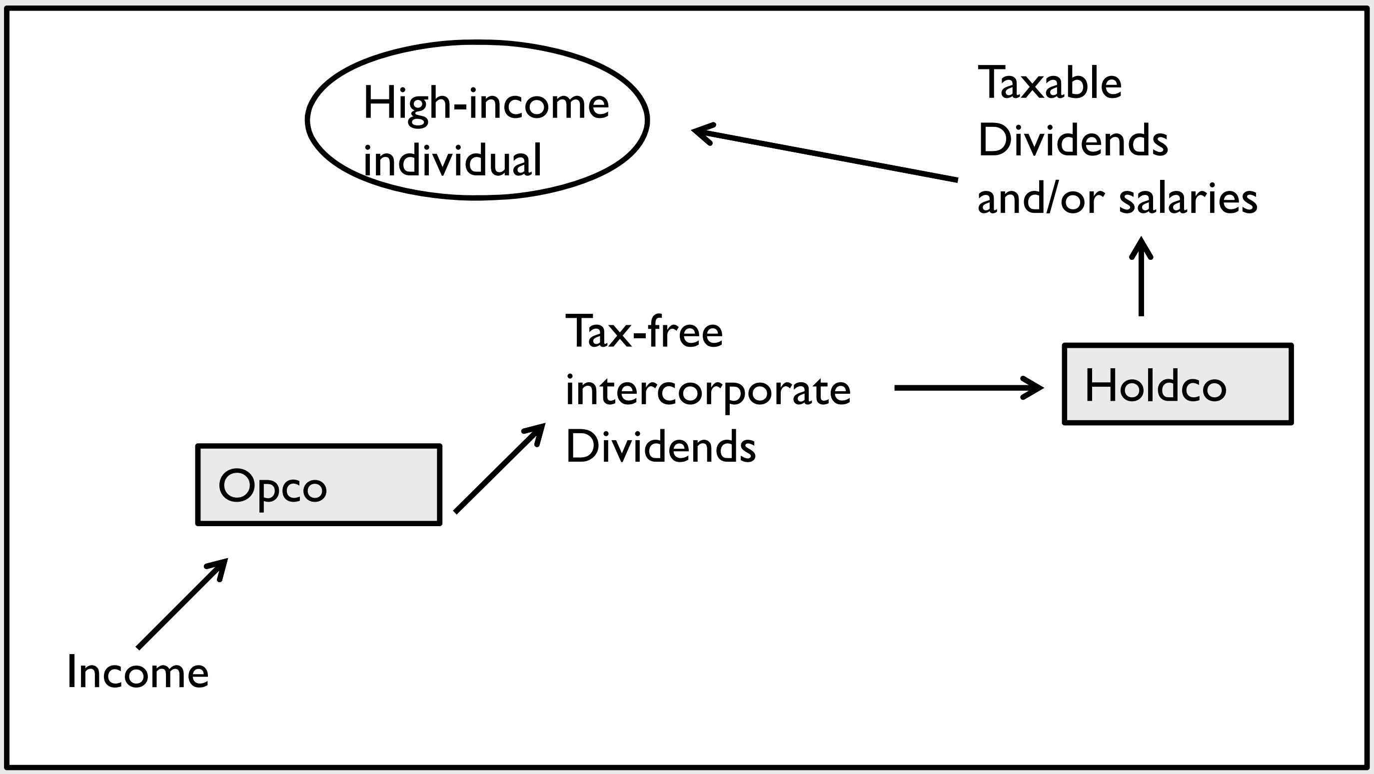
OVERVIEW

Our goal is to focus on the following questions:

- Why are holding companies so common among higher net worth individuals?
- How is investment income taxed in a corporation and how does this compare to taxation of individuals? Is it better or worse to hold investments corporately rather than personally?
- How do we help with estate planning for individuals who have corporations that will cause significant capital gains tax at death?
- Questions

Why Do So Many Holdco's exist?

- Most often, investment holding companies arise as a result of successful entrepreneurs who have made money in their business and not wished to pay the full personal level of tax
- Holdco provides a safe place to invest the earnings outside the operating company



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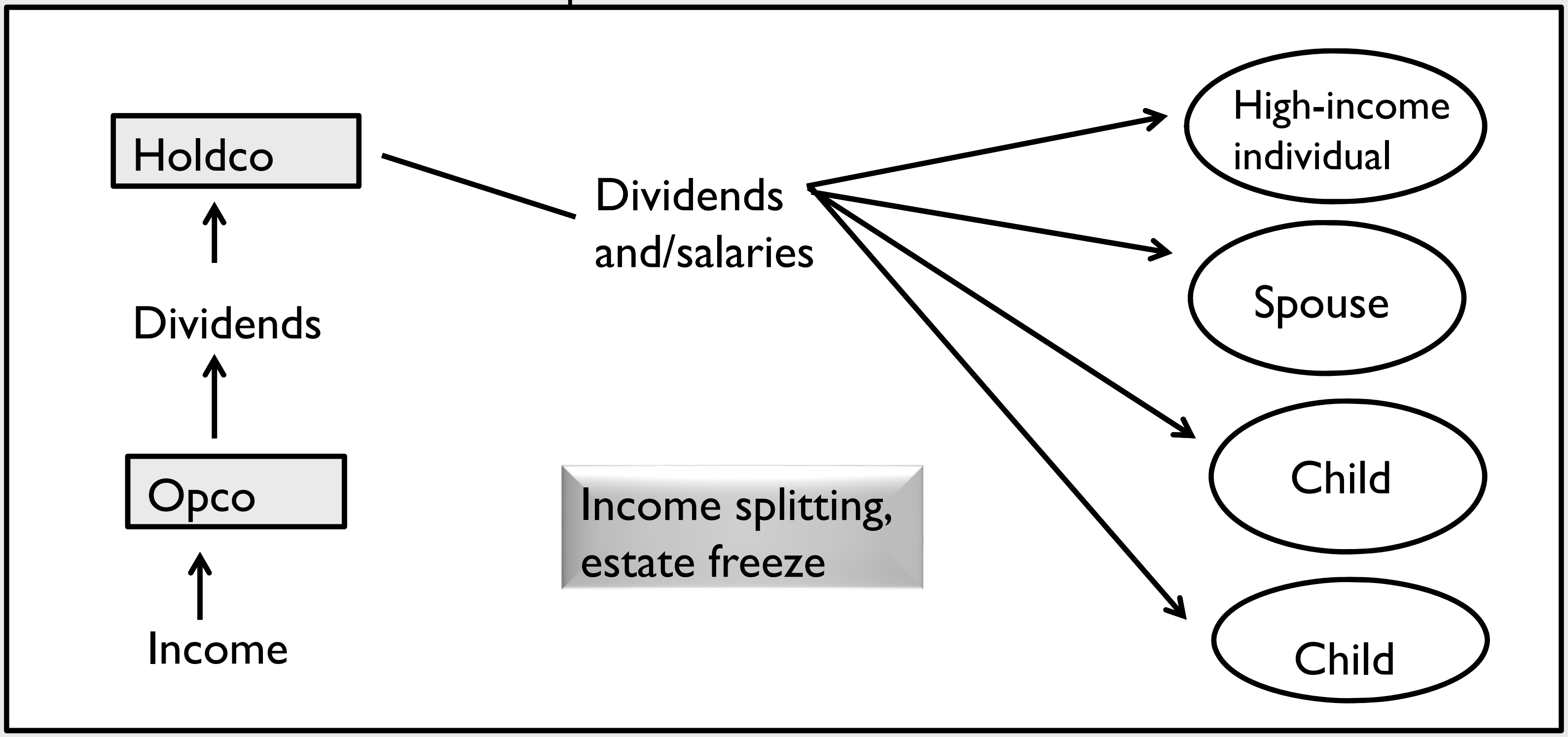
Advantages of Leaving $ in Holdco

Overall Canadian tax savings or tax deferral

- Major deferral given spread between personal and corporate rates
- Significant savings but only if an individual expects to be in a lower tax bracket when the funds are removed from the corporation
- Significant saving when splitting income with multiple family members
- However beware of pitfalls that arise from attribution rules

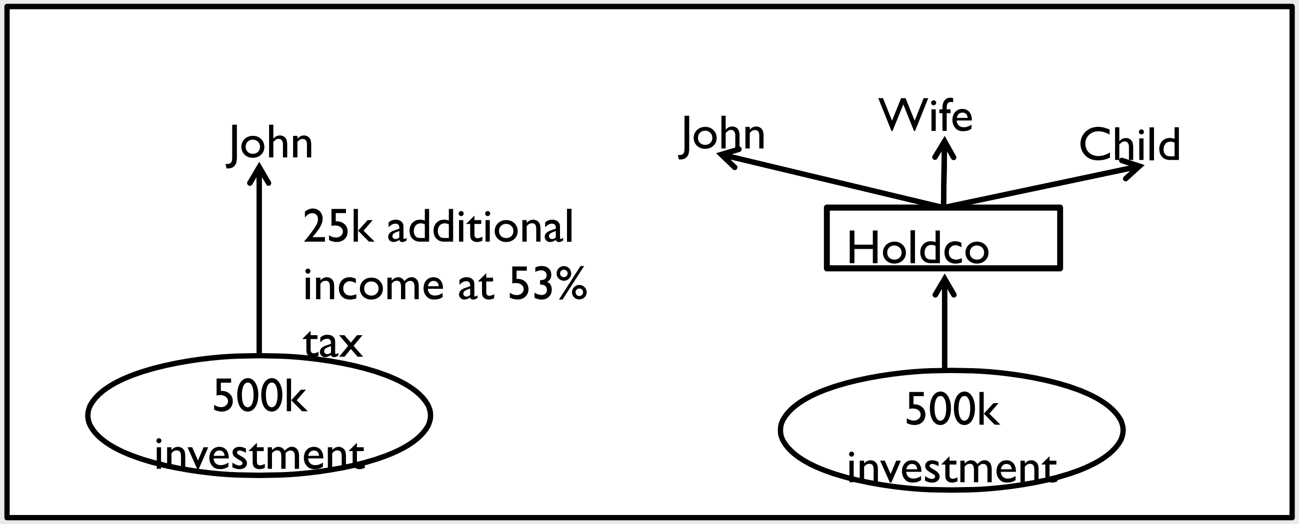


Pitfall: Attribution Rules

Corporate attribution applies if the following two conditions are present:

I. property was transferred or loaned to a corporation, and

II. the main purpose of the transfer or loan may reasonably be considered to reduce the income of the transferor and to benefit a designated person (spouse or minor child under 18 years of age).



Result:

➢ Corporate attribution effectively reduces or eliminates the income splitting benefit by attaching a deemed interest rate to the consideration received on the transfer, thereby requiring the transferor to include into income a deemed taxable benefit. This taxable benefit is punitive because it results in taxable income to the transferor with no corresponding deduction to the company.

Another reason for Holdco's: US Estate Tax

- US estate planning - A liability for US estate tax can arise if a US non-resident individual holds US securities, substantial US real property at death. Holding assets in a Canadian-incorporated company is a common technique to avoid US estate tax.

- The US estate tax even applies for assets held directly in a RRSP or RRIF.

- Shares of a Canadian corporation are exempt from US estate tax provided the corporation has the beneficial and legal ownership of its assets. This is true even if the corporation owns only assets that would otherwise be subject to US estate tax.

How is investment income taxed in an investment corporation?

Dividends

- Dividends received by a Canadian controlled private corporation from a connected Canadian corporation earning active income are not subject to tax

- Canadian portfolio dividends (that is, dividends from non-connected corporations) are most likely to be eligible dividends and are taxed at 38.3%.

- When you are in the top personal tax bracket, there is a tax deferral of 1% available by receiving a dividend corporately rather than personally. If you are in a lower tax bracket, earning portfolio dividend would cause you to pay more tax upfront because of this tax

- The key is to understand that this is refundable tax that is paid back when the company issues dividends to its shareholders. When dividends are paid from a holding company the company gets back the refundable tax while the individual pays at their marginal rate. This is the reason why it can make sense for an individual at high rates to earn investment income in a holdco and then take it out when his/her income is substantially lower.

How is investment income taxed in an investment corporation?

Integrated Tax Rates
Eligible Dividends

Taxation Year	2016	2016	2016	2016
Taxable Income	> $138,586	> $150,000	> $200,000	> $220,000
Corporate tax rate	38.33	38.33	38.33	38.33
Tax rate on eligible dividends	29.52	31.67	37.19	39.34
Effective tax rate after eligible dividends	29.52	31.67	37.19	39.34
Personal tax rate	29.52	31.67	37.19	39.34
Potential deferral	-8.81	-6.66	-1.14	1.01
Savings (cost)	0.00	0.00	0.00	0.00

How is investment income taxed in an investment corporation?

Capital Gains

- If you are in the top personal tax bracket, there is a tax deferral of about 1.7% when income is earned
- When the corporately taxed income is subsequently distributed to the shareholder as a non-eligible taxable dividend, an ultimate tax cost of about 2.3% exists

How is investment income taxed in an investment corporation?

Integrated Tax Rates
Capital Gains

Taxation Year	2016	2016	2016	2016
Taxable Income	> $138,586	> $150,000	> $200,000	> $220,000
Corporate tax rate	25.09	25.09	25.09	25.09
Tax rate on ineligible dividends	37.00	38.82	43.50	45.33
Effective tax rate after ineligible dividends	25.90	26.60	28.39	29.09
Personal tax rate	23.21	23.99	25.99	26.77
Potential deferral	-1.88	-1.10	0.90	1.68
Savings (cost)	-2.70	-2.61	-2.40	-2.32

How is investment income taxed in an investment corporation?

Interest, rent and other Canadian investment income

- If you are in the top personal tax bracket, there is a deferral of 3% when income is earned
- When the corporately taxed income is subsequently distributed to the shareholder as a non-eligible taxable dividend, an ultimate tax cost of 5% exists
- Once again the key is to understand the refundable tax mechanism. Of the tax that is charged, approximately 27% is a refundable temporary tax. When dividends are paid from a holding company the company gets back the refundable tax while the individual pays at their marginal rate. This is the reason why it can make sense for an individual at high rates to earn investment income in a holdco and then take it out when his/her income is substantially lower.

How is investment income taxed in an investment corporation?

Integrated Tax Rates
Interest and Other Income and Ineligible Dividends

Taxation Year	2016	2016	2016	2016
Taxable Income	> $138,586	> $150,000	> $200,000	> $220,000
Corporate tax rate	50.17	50.17	50.17	50.17
Tax rate on ineligible dividends	37.00	38.82	43.50	45.33
Effective tax rate after ineligible dividends	51.81	53.20	56.78	58.18
Personal tax rate	46.41	47.97	51.97	53.53
Potential deferral	-3.76	-2.20	1.80	3.36
Savings (cost)	-5.40	-5.23	-4.81	-4.65

How is investment income taxed in an investment corporation?

Foreign investment income

- Generally taxed in a manner similar to interest and other Canadian investment income
- Foreign taxes paid is recognized in Canadian as a foreign tax credit
- If you are in the top personal tax bracket, there is a deferral of 3% when income is earned
- When the corporately taxed income is subsequently distributed to the shareholder as a non-eligible taxable dividend, the ultimate tax cost will be higher than 5% because of the way foreign tax credit is deducted

Planning for when Integration Works the Wrong Way!

- If the effective tax rates by flowing income through a holding company causes a serious problem for the owner, then a solution might be to wind up the IHC. However, once an IHC is formed it can be very expensive to wind it up because removing the funds from the holding company will mean the payment of a significant dividend taxed at approximately 40%.

- There are less extreme steps that could be taken. For example, a shareholder of an IHC might consider the following ways to pay tax-deductible money out of a corporation:
  1) paying a salary (key is reasonable salary)
  2) paying a management fee

Estate Implications and planning

- A the time of death of a taxpayer, all assets are deemed to have been disposed and the value of any shares held will result in an immediate capital gain and resulting tax bill (subject to the deferral available if there is a spousal roll-over)

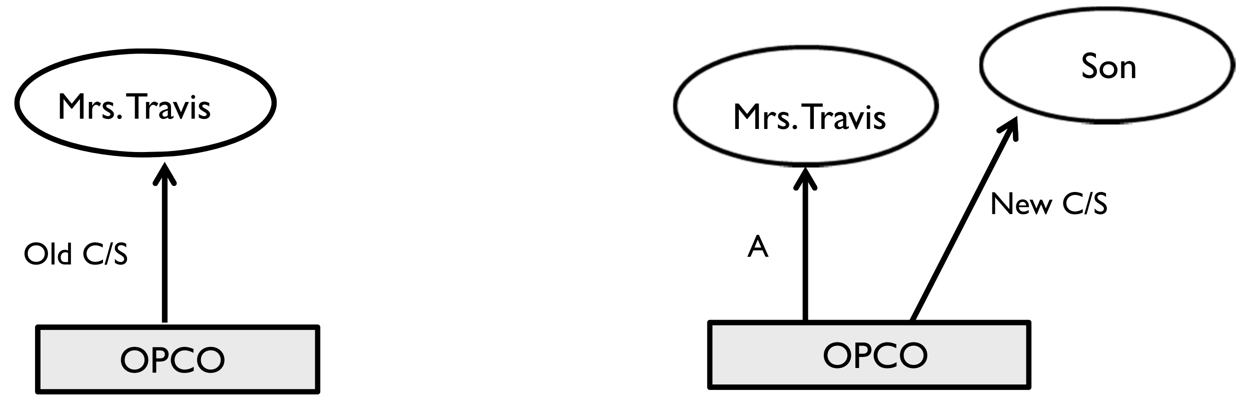
- The lifetime capital gains exemption on the sale of qualified small business corporation shares is now $824,176 (indexed annually). This can help mitigate the tax hit for small business (but not investment holdco's).

- To minimize the tax hit at death, we could freeze the value (and tax liability) of a capital property for an owner, and provide growth shares to another person (or a trust for the family)

Example: Fifteen years ago, Mrs. Travis incorporated a business (Opco.) by subscribing for 100 common shares at a price of $100. The company is doing well. It is worth $2 million. Her valuators told her that at the current annual rate of return for the business, her shares should be worth more than $4,000,000 within eight to ten years.

Estate planning for corporations with trapped retained earnings

Estate Freeze



A = new fixed-value preferred shares, equal in value of the Mrs. Travis's common shares of Opco
New C/S = new common shares with initial value equal to their paid-up amount

- If Mrs. Travis were to decide today to carry out an estate freeze, she would retain freeze shares worth $2 million and her son, by holding new common shares of the company, would benefit from the future appreciation in value
- If Mrs. Travis were to die in ten years, the capital gain at that time only be on the freeze value
- Furthermore, the freeze would make it possible to determine the amount of the tax liability with a certain degree of certainty and develop financing strategies for it, where applicable, by making use, for example, of insurance

Freeze + Redeem

Concept:

- Post freeze the "freezor" has their shares redeemed by the Holdco
- The redemptions are treated personally as dividends
- The Corporation uses the Capital Dividend Account and Refundable Tax on Hand to redeem the shares so that the redemption causes almost no incremental tax
- The result is that the individual receives taxable dividends, the company gets tax back, and the tax on death is reduced or eliminated

Freeze and Redeem Illustration

Illustration assumes 70% invested in interest bearing at 5% and 30% in equities at 3% dividend and 4% capital gain

Year	Opening Value	Investment Income Interest	Dividends	Cap Gains	Permanent Tax	Refundable Tax	Share Redemption	Closing Balance	Freeze Shares	Common Shares
2008	28,000	980	252	336	264	390	1,169	28,135	26,831	1,304
2009	28,135	703	422	563	226	402	1,206	28,391	25,626	2,766
2010	28,391	710	426	568	229	406	1,217	28,650	24,409	4,241
2011	28,650	716	430	573	231	409	1,228	28,910	23,181	5,729
2012	28,910	723	434	578	233	413	1,239	29,173	21,942	7,231
2013	29,173	729	438	583	235	417	1,250	29,438	20,692	8,746
2014	29,438	736	442	589	237	421	1,262	29,706	19,431	10,276
2015	29,706	743	446	594	239	424	1,273	29,976	18,157	11,819
2016	29,976	749	450	600	241	428	1,285	30,249	16,873	13,376
2017	30,249	756	454	605	244	432	1,296	30,524	15,577	14,948
2018	30,524	763	458	610	246	436	1,308	30,802	14,268	16,533
2019	30,802	770	462	616	248	440	1,320	31,082	12,948	18,133
2020	31,082	777	466	622	250	444	1,332	31,364	11,616	19,748
2021	31,364	784	470	627	252	448	1,344	31,650	10,272	21,378
2022	31,650	791	475	633	255	452	1,356	31,938	8,916	23,022
2023	31,938	798	479	639	257	456	1,369	32,228	7,547	24,681
2024	32,228	806	483	645	259	460	1,381	32,521	6,166	26,355
2025	32,521	813	488	650	262	465	1,394	32,817	4,772	28,045
2026	32,817	820	492	656	264	469	1,406	33,115	3,366	29,749
2027	33,115	828	497	662	267	473	1,419	33,417	1,947	31,470
2028	33,417	835	501	668	269	477	1,432	33,721	515	33,206

Estate planning for corporations with trapped retained earnings

Use of Insurance

Life insurance policies owned by a holding company can be used to fund one's retirement when the operating company is sold, wound down or transferred to their children active in the business.

Advantages:

- Policy ownership will not have to be transferred on sale of an operating company
- Cash values in a holding company can be used to supplement retirement income
- Holding companies can own different assets such as real estate and other investments. The life insurance policy can be used to pay for future tax liabilities of the shareholders estate.
- Investments inside a tax exempt universal life or whole life insurance policy grow tax-deferred
- The tax free benefit the holding company receives can be used to pass down some or all of the proceeds through a tax free capital dividend account
- Potential for protection from creditors of operating company

Disadvantages:

- Cash surrender value could affect the qualified small business corporation status for purposes of the enhanced capital gains exemption
- The insurance premiums are (generally) not deductible
- Policy gains and taxable income may arise on future transfer of ownership of the policy

Key Learnings

- ***Holding company can be used to split income with family members or receive income after retirement when shareholders are in lower tax brackets (pay attention to attribution rule)***
- ***Assets held in Canadian holding company is exempt from US estate tax***
- ***Holding company defers tax on investment income if you are in the highest personal tax bracket. It does not provide absolute tax saving***
- ***Use insurance to fund your retirement, estate tax***

Questions/Discussion