THE GLOBE AND MAIL

CESTNICK

TAX MATTERS

Beware of double-taxation on holding companies

SPECIAL TO THE GLOBE AND MAIL
PUBLISHED OCTOBER 18, 2018
UPDATED OCTOBER 19, 2018

Last week I played what will likely be my last round of golf for the year. I played with my good friend Bruce and his buddy Bill. Now, Bruce and Bill golf together all the time and they're getting on in years. At every tee box I heard the same thing: "Bill, my eyes aren't as good as they used to be. Did you see where my ball went?" Bruce would ask. "Not a chance," Bill would reply, "my eyes are worse than yours."

So, I spent the better part of 18 holes finding golf balls, and sharing tax advice. Bruce and Bill are both business owners, and both own private corporations. It's been a tough year for small business owners with the tax changes to private corporations, so I felt badly telling them about another problem they're going to face when they pass away. It's a double-tax problem. Let me explain.

THE ISSUE

Perhaps you own a holding company that has assets of meaningful value. The assets could be real estate, marketable securities or anything else. Holding companies like this often exist because an individual might have owned an active business in the past and over time may have paid dividends to the holding company out of surplus earnings of the business. Holding companies often become the "pension plan" of the business owner.

Or perhaps you have transferred assets to a holding company because certain assets (rental real estate comes to mind) are often better held in a corporation that offers some protection from liability. Whatever the case, holding companies are very common.

The problem is that, as the value of the assets in the holding company grows, a double-tax problem arises. Suppose, for example, that you own a holding company that holds assets worth, say,

$2-million, with no liabilities to speak of. So, the value of your shares in that holding company will be $2-million.

What happens when you die? You'll be deemed to have sold those shares at fair market value. You'll pay tax on the capital gain at that time. The exception is where you leave those shares to a surviving spouse, in which case the taxable capital gain is deferred until your spouse passes away. But eventually, the gain on those holding company shares will be taxable. As the assets inside the holding company grow in value, the shares of your holding company grow in value, and the eventual tax bill also grows. This tax on the holding company shares is the first level of tax to be paid.

But there's a second level of tax. As the assets of the corporation grow in value, the corporation itself will eventually pay tax on any capital gain when it sells those assets. Can you see what's happening here? As the assets of the holding company grow, so does the tax bill that will be paid by the shareholder when he dies. And the tax bill owing by the corporation itself will also grow as its assets grow in value. This is a double-tax problem. The same growth in value is being taxed twice.

THE EXAMPLE

Let's consider Bruce. Suppose he owns a holding company which, in turn, used to own shares of an active business operated by Bruce. Over the years, the operating business generated surplus cash that Bruce paid to his holding company as dividends because he wanted to protect that cash from creditors of his business. Bruce routinely paid dividends to his holding company and today there is $2-million worth of marketable securities in his holding company. The adjusted cost base (ACB) to the corporation of those investments is, say, $1.2-million, so the corporation will eventually have an $800,000 capital gain to report.

But Bruce will eventually have a capital gain to report on his own personal tax return, too. If Bruce were to die tomorrow, there would be a $2-million capital gain realized on the shares of his holding company (assuming a nominal ACB and that he's not leaving his shares to his spouse). The tax bill owing on these shares would be $535,300 since Bruce is in the highest tax bracket in Ontario.

Bruce's children will be inheriting his holding company shares. If they decide to sell the assets inside the holding company, there will be an $800,000 capital gain triggered at that time ($2-million less the ACB of $1.2-million). This $800,000 has already been taxed in Bruce's hands when he was deemed to have sold his company shares when he died. Therein lies the double-tax problem.

In fact, when his kids decide to pay the proceeds inside the holding company to themselves as dividends, there will be a third level of tax on the amounts they receive from the holding company.

Layers of tax can get expensive. I'll share a solution to the problem next time.

Tim Cestnick, FCPA, FCA, CPA(IL), CFP, TEP, is an author, and co-founder and CEO of Our Family Office Inc.