



CESTNICK

TAX MATTERS

Consider different options to solve a holding company double-tax problem

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Last week I shared the example of a taxpayer named Wendy who owns \$1-million of investments. I compared the taxes owing after her death if she owned them personally versus in a holding company. In the latter situation, she would be the sole shareholder of the company. There are three layers of tax that arise with a corporation: (1) the capital gain on death on the shares of the corporation itself, (2) the capital gain inside the corporation when it sells its investments, and (3) the tax on dividends when the proceeds are paid out to the heirs. These are all taxes on the same growth in value.

In my example, the math showed that Wendy would owe \$312,500 in taxes on death if she owned the portfolio personally, but \$683,377 if the portfolio was in a holding company – factoring in the three layers of tax.

In Wendy's example, I assumed an adjusted cost base (ACB) of just \$1 for the portfolio. Some criticized this and suggested I was inflating the double-tax problem. But if I had used a higher ACB of, say \$600,000, the gap between the

personal and corporate portfolio would have been even wider. The bottom line? Regardless of the ACB of the assets, the double-tax issue is a consistent problem. Here are three ways to address it.

The Solutions

If you have a holding company, there are three common solutions to the double-tax problem. Each idea can potentially reduce or eliminate one of the three layers of tax. Check these out.

Solution No. 1: The Carryback

This idea can eliminate the first layer of tax owing on the capital gain triggered on death on your holding company shares. Let's continue with Wendy's example. After her death, Wendy's executor will redeem (that is, sell back to the holding company itself) the \$1-million worth of shares in her holding company held by her estate. This needs to take place in the first taxation year of the estate. The payment received by her estate in exchange for the shares is generally taxable as a deemed dividend. Now, because of how the math works (I won't

bore you with it here), there will also be a capital loss in her estate. This loss can be carried back to Wendy's final tax return to offset the capital gain realized on the holding company shares when she dies. Subsection 164(6) of our tax law allows this to happen. If we use The Carryback move in our example above, the total taxes owing could be reduced to \$390,207.

Solution No. 2: The Bump

This idea will eliminate the second layer of tax owing by the corporation when it sells the assets it owns. How? By "bumping up" the ACB of the assets inside the company and eliminating the capital gain on those assets using paragraph 88(1)(d) of our tax law. Back to our example. After Wendy dies, her estate will receive her holding company shares with a value of \$1-million and an ACB of \$1-million (she will have already paid tax on the \$1-million gain – so her estate inherits a high ACB). So, her estate could sell those shares to a newly formed holding company (Newco) with no tax to pay. Then, her executor could amalgamate the holding company and Newco. Assuming certain conditions are met, the ACB of the assets in the amalgamated company can be bumped up at that time to a value as high as \$1-million in our example. If we use The Bump in our example above, the total taxes owing could be reduced to \$312,500.

Move No. 3: The Pipeline

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This idea will eliminate the third layer of tax owing when the corporation distributes its assets to your estate, and ultimately your heirs. How? By creating a tax-free pipeline to allow your estate to

remove assets from the holding company. Think of Wendy's example. Just like The Bump strategy, her estate could sell her holding company shares to a new holding company (Newco). Newco would pay her estate for the shares of her holding company with a \$1-million promissory note. (A promissory note is simply a legal agreement which requires one party to pay another at a certain time, or upon demand.) It may then be possible to wind up the holding company into Newco and distribute the assets out of Newco to her estate over time as a tax-free payment of the promissory note. There are certain conditions that should be met for the pipeline strategy to work – so speak to a tax pro. The tax bill in our example could be reduced to \$645,833 with The Pipeline.

These three ideas can be used in isolation from each other, or a combination of them could make sense. The best approach depends on a number of factors and your tax adviser can do the math to see what's best in your case.

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