canada life™

Why incorporate? Why use a holding company?

A corporation is by far the most popular business vehicle that's used by business owners. This article discusses why small and medium sized business owners incorporate and why many of them use a holding company.

Using a corporation

There are four main reasons why a business owner would choose to incorporate. The first reason identified below is business related and latter three are tax related.

1. Creditor protection
2. Access to low tax rates
3. Tax deferral on profits
4. Access to the lifetime capital gains exemption

Protection from business creditors

For legal purposes a corporation is treated as a separate person. This offers shareholders protection from the corporation's creditors. For example, if you carried on an unincorporated business that manufactures lawnmowers and a manufacturing defect arose which caused an injury to a customer, that injured person could sue you and, if successful, all of your personal assets would be exposed to satisfy the damages award. In contrast, if instead you were a shareholder of a corporation that carried the lawnmower manufacturing business, only the corporation's assets would be exposed to the claim of the injured person. This liability protection is important to business owners because it incentivizes individuals to pursue commercial activities without putting their personal wealth at risk.

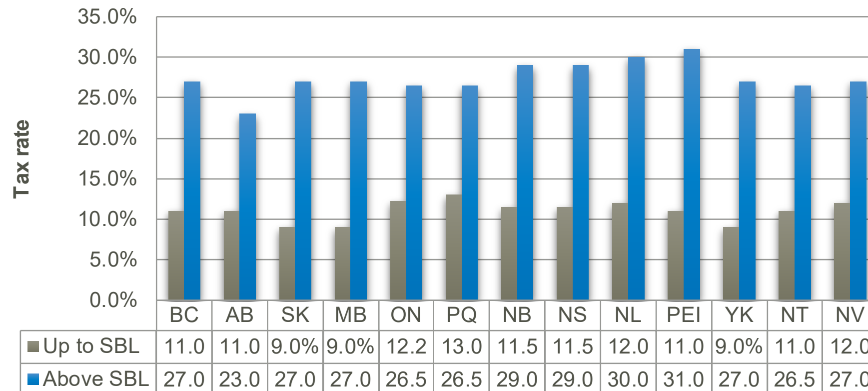
There are limits to the creditor protection offered by corporations. Often lenders will ask a shareholder to give a personal guarantee to a loan extended to their corporation. In other cases, a creditor could "pierce the corporate veil" in instances where a shareholder or director uses a corporation for illegal, fraudulent, or improper purposes. Provincial fraudulent conveyance legislation applies to corporations as well, enabling a creditor access to assets that the debtor corporation transferred to delay, hinder or defraud creditors. Also, professional corporations don't offer creditor protection against professional negligence claims.

Low corporate tax rates on active business income

Corporations generally have two tax rates applicable to their active business income, meaning income from a business activity and not from passive sources like rent, interest and royalties. The first tax rate is the small business rate of approximately 12% in many provinces, and it applies to the corporation's first $500,000 of active business income. This $500,000 threshold is called the small business limit ("SBL") and it applies in all provinces and territories except in Saskatchewan where the provincial SBL is $600,000. The second tax rate is still relatively low at approximately 27% in many provinces, and it applies to active business income that's over the SBL. The table below shows the tax rates for active business income below and above the SBL in each province and territory as of January 1, 2022.

This material is for information purposes only and should not be construed as providing legal or tax advice. Reasonable efforts have been made to ensure its accuracy, but errors and omissions are possible. All comments related to taxation are general in nature and are based on current Canadian tax legislation and interpretations for Canadian residents, which is subject to change. For individual circumstances, consult with your legal or tax professional. This information is provided by The Canada Life Assurance Company and is current as of March 2022.

Canada Life and design are trademarks of The Canada Life Assurance Company.



	BC	AB	SK	MB	ON	PQ	NB	NS	NL	PEI	YK	NT	NV
Up to SBL	11.0	11.0	9.0%	9.0%	12.2	13.0	11.5	11.5	12.0	11.0	9.0%	11.0	12.0
Above SBL	27.0	23.0	27.0	27.0	26.5	26.5	29.0	29.0	30.0	31.0	27.0	26.5	27.0

As a result of these low tax rates relative to high personal rates, there's a significant tax incentive to incorporate. The lower tax rates on business income results in more after-tax income to either reinvest in the business or purchase financial assets, like marketable securities or life insurance.

Tax-deferral on profits and potential retirement savings

Achieving a tax-deferral means you're taking steps to have less personal income today than you otherwise would have had, but the deferred income could nevertheless provide personal income at a later date. Contributing to a registered retirement savings plan (RRSP) is a popular tax deferral strategy – the contribution provides a tax deduction today, but the later withdrawal is taxable.

In the business context, individuals carrying on a business as sole proprietors are taxed at their personal marginal tax rates on their business income. In contrast, when a corporation carries on business its earnings are taxed at the corporate level first and then those funds are taxed again when distributed to shareholder(s) as a taxable dividend. In practice these two levels of tax should equal the amount of tax paid by the sole proprietor earning the same amount of business income. This is called tax integration; however, perfect tax integration is rarely achieved.

You'll notice that there's an opportunity to have the corporation's after-tax earnings retained at the corporate level, and not paid out to the shareholder as a taxable distribution, if those funds aren't needed by the shareholder. Business owners can achieve a tax-deferral by acting on this incentive and keeping their corporations' after-tax earnings at the corporate level. Taking advantage of this tax-deferral is the main reason why successful business owners often have their retirement nest egg held at the corporate level and not held personally.

Let's look at an example. If your corporation has $100 of net profits that are taxed at 10%, it will have $90 leftover to either reinvest in the business or in financial assets. If your corporation paid out the $90 as a taxable dividend to you then you might pay approximately $40 of income tax and have $50 after-tax leftover. The point is that you have the choice to leave the $90 of after-tax earnings in the corporation. In contrast, if you instead carried on business as a sole proprietor and had a 50% marginal tax rate, your $100 of profits would leave you with $50 after-tax. With this example you can see that simply by incorporating, the business owner can potentially achieve a $40 tax-deferral.

Canada Life and design are trademarks of The Canada Life Assurance Company.

This example is illustrated in this table which also includes the deferral advantage of active business income taxed at an assumed general corporate rate of 27%.

	Corporate (Small business rate)	Corporate (General rate)	Sole proprietor
Profit	$100	$100	$100
Tax rate	10%	27%	50%
After-tax	$90	$73	$50
Tax-deferral	$40	$23	-

Access to the lifetime capital gains exemption

The lifetime capital gain exemption is a significant tax benefit available to shareholders who sell, or are deemed to dispose of for tax purposes, their “qualifying small business corporation shares” (“QSBC share”). Generally, a QSBC share is a share of a Canadian-controlled private corporation of which at least 90% of the value of its assets are principally used in an active business carried on primarily in Canada. There are also other shareholder holding period and time related tests that apply. The exemption amount is indexed annually and in 2022 it would provide a deduction that offsets a capital gain of $913,630 on sale or disposition of QSBC shares. This results in a tax savings of $228,408, assuming a 50% marginal tax rate. Owners of qualified farm or fishing property are eligible for an enhanced $1,000,000 lifetime capital gains exemption, which assuming a 50% marginal tax rate translates into $250,000 of tax savings.

Business owners who plan to sell their business at least several years in the future may carry out strategic tax planning, such as an estate freeze, to potentially multiply the use of the lifetime capital gain exemption amongst other family members.

Considerations when incorporating a business

Clients should consult with their legal and tax advisors before setting up a corporation. The following tax, legal and business items may be considered:

- Will the business endure and be part of a succession plan? If so, incorporating will provide more options for estate planning and/or preparing the business for a sale to a third party.
- If there are business partners, will there be a shareholders’ agreement and how will the buyout clauses be funded, who will be the officers and directors?
- How will the owner-manager client be compensated? Dividends, salary, or both?
- Will all of the business assets, such as intellectual property, be transferred to the corporation and will it be done on a tax-deferred basis?
- How does corporate wealth accumulation affect the client’s estate planning?
- Are there other family members who could be shareholders and benefit from an income-splitting strategy?

Using a holding company

A holding company (Holdco) is a corporation positioned between the individual shareholder and an operating company (Opco). The shareholder owns the shares of Holdco and Holdco owns all or part of the shares of Opco. A Holdco is useful for at least two reasons, it allows:

Canada Life and design are trademarks of The Canada Life Assurance Company.

1. For a business owner to insulate corporate assets from potential creditors of the operating company
2. A means of managing the movement of funds within a corporate group.

The key feature that a Holdco has in comparison to an individual shareholder is its ability to achieve these two objectives without needing to make a taxable distribution from an Opco. Generally, a corporation can pay a tax-free intercorporate dividend to a corporate shareholder where the two corporations are "connected" for tax purposes. Connected corporations exist where Holdco controls Opco or where Holdco owns shares of Opco having more than 10% of the votes and value of that corporation. Control in this context means where either Holdco, or someone not at arm's length with Holdco, owns more than 50% of the shares of Opco, having full voting rights. As a result, where Holdco and Opco are connected, Opco may be able to pay tax-free intercorporate dividends to Holdco.

An important technical point is that Holdco shares in Opco must have either enough "safe income" attributed to them, or rely on an exception, to avoid the application of subsection 55(2) of the Income Tax Act ("ITA") which could recharacterize a tax-free intercorporate dividend into a capital gain.

Creditor protection

As noted, Opcos are used to protect the individual shareholder's personal assets from business creditors. Holdcos are used to protect corporate assets from business creditors and they do so in the following way.

Assume Opco has retained earnings that it wants to insulate from potential business creditors. Also assume that Holdco owns all the shares of Opco resulting in them being "connected" and that any subsection 55(2) issues are addressed. To creditor protect its retained earnings, Opco could distribute its retained earnings to Holdco as a tax-free intercorporate dividend. The dividend proceeds received by Holdco could either remain in Holdco and be insulated from Opco's creditors or be loaned back to Opco if they're needed in the business. The loan may be secured by Holdco taking a security interest over Opco's assets, making Holdco a secured creditor.

Using a Holdco in this manner is commonplace and, as noted, often results in the business owner's retirement savings held at the Holdco level. This creates estate planning issues to deal with including:

1. An increase in the value of the shares held by the individual shareholder, resulting in potential capital gains taxes at death
2. Tax planning for efficiently transferring this corporate wealth to a surviving spouse or the next generation.

Corporate owned life insurance is an effective way of providing liquidity to deal with taxes at death and is also a tax-efficient way of distributing corporate wealth after death. See Canada Life's TEPG article titled, "Corporate-owned life insurance" for more information.

Managing corporate funds transfers within a corporate group

As a business expands, its corporate group will often expand as well by including other corporations that play a part in the business owner's planning. For example, a business my operate through an operating company (Opco 1), but its land, building and plant equipment may be owned by another operating company (Opco 2) for creditor protection and possibly other planning purposes. These hard assets may initially be owned in Opco 1 and subsequently be transferred to Opco 2 on a tax-deferred basis through a so-called "butterfly" transaction or

the assets may be initially purchased by Opco 2 with funds earned within Opco 1. But how can Opco 1 transfer funds to Opco 2 to make these purchases?

If Opco 1 transferred funds to Opco 2 then it could cause tax issues for their shareholder (Holdco). Alternatively, if Opco 1 lent the funds to Opco 2, then that loan would be an asset of Opco 1 which would be exposed to its creditors. Opco 1 could instead pay a tax-free intercorporate dividend to Holdco which it could then transfer or lend to Opco 2 to buy the land, building or equipment. This results in a clean transfer of funds from Opco 1 to Opco 2.

Considerations when using a holding company

Clients should consult with their legal and tax advisors before setting up a Holdco. The following items should be considered so that the holding company structure doesn't result in unwanted tax issues:

- That the individual shareholder may transfer their shares of Opco to Holdco on a tax-deferred basis
- That Holdco and Opco are connected, as described above, and that sufficient safe income or an exemption to the application of subsection 55(2) will apply to intercorporate dividends
- That the individual shareholders either crystallize or preserve their ability to use their lifetime capital gains exemption

Canada Life and design are trademarks of The Canada Life Assurance Company.