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BUSINESS OWNERS CAN MAXIMIZE CHARITABLE GIVING BY USING A HOLDING COMPANY

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Some of the biggest charitable donations or legacy gifts in Canada have been made by successful business owners. However, no matter what the size of your business is, if charitable giving and leaving a legacy is important to you, then you should explore ways of using our tax rules to maximize the impact of your charitable giving.

OUR TAX RULES provide a favourable tax rate for Canadian Controlled Private Corporations (CCPC). The first $500,000 of income of a Canadian-controlled Private Corporation (CCPC) enjoys a very low federal small business tax of 12.2%. Until 2018, the small business rate was available on active business income up to the amount of the Business Limit and the federal business limit of $500,000 began to be reduced when a CCPC's taxable capital reached $10 million, and was eliminated when taxable capital reached $15 million.

The 2018 Budget measures eroded the Small Business Deduction (SBD) limit of $500K that is available for Canadian Controlled Private Corporations (CCPC) based on the amount of passive income generated within a corporation (and associated corporations). After the 2018 Budget, the business limit will be reduced when investment income is greater than $50,000 on a straight-line basis and eliminated when investment income is $150,000 in a year.

This grind will operate in conjunction with the existing reduction to the SBD limits that occurs for taxable capital over $10M, and the reduction to the SBD will be the greater of the two possible outcomes where applicable.

As part of the measures announced in the 2018 Budget, there will be a modification to the existing Aggregate Investment Income and the introduction of a new concept, "Adjusted Aggregate Investment Income". Capital gains (losses) realized from disposition of active business assets and shares of a connected CCPC that operates an active business will be excluded from the calculation of Aggregate Investment Income. Accordingly, the gains on these types of investments will not impact the availability of the SBD.

The new SBD grind will be an annualized test based on the prior year's investment income. As a result, a corporation could lose the SBD one year and regain it the next year if investment income goes down.

In 2021, CCPCs that are eligible for the small business deduction pay the following combined federal and provincial (Ontario) tax rates on different types of income***:

General Rate – 26.50%
Small Business (to $500,000) – 12.5%
Investment – 50.0%

When money is withdrawn from the corporation, it will be taxed at the top marginal tax bracket of the owner, depending on the amount of income he/she declares in that year. If the owner's net income is over $220,000 in Ontario, and the amount that is withdrawn from the corporation is in the form of salary, the income would be taxed at 53.53%. If it is withdrawn in the form of non-eligible dividends, then it would be taxed at 47.74%.

Holding Companies

The cash inside an operating company can be transferred to a holding company using inter corporate dividends, on a tax-free basis. Business owners set up holding companies mainly either to protect themselves from claims of creditors or as a retirement strategy to set up an investment portfolio inside the corporation without having to withdraw any funds and then to withdraw the funds as dividends during retirement.

While the low tax rate for small businesses helps spur growth in the business sector and helps the business owners accumulate wealth, this wealth creates complexity.

The biggest dilemma for most business owners is how to extract the funds in their corporations and holding companies without paying personal taxes at very high rates, due to those funds being taxed as personal income upon extraction from the company. There can be substantial reduction in the value of a company upon withdrawal of the funds. For example, assuming a 47.74% tax rate, a holding company with a value of $3,000,000, is only worth $1,567,800 after tax (assuming that the Lifetime Capital Gains Exemption of $892,218 has already been used).

Therefore, it is understandable that business owners are always looking for tax effective methods of extracting their locked -p capital from their corporations.

Passive Income

The passive income rules that came into effect pursuant to the 2018 Budget have meant that business owners are constantly looking for ways of reducing their passive income to be able to take advantage of the full Small Business Deduction of $500,000 and the favourable tax rates on income below this threshold.

Moving passive investments from an operating company to a holding company via non-taxable inter-corporate dividends not only provides creditor protection for savings that grow inside the holding company but also allows business owners to minimize passive income inside their operating companies.

Owning a corporate owned permanent life insurance policy that provides tax deferred growth and charitable giving can be other solutions for reducing passive income in a corporation.

Charitable Giving

When a corporation makes a charitable gift, the corporation receives a tax deduction, which reduces its income and will therefore reduce the taxes it has to pay. When a charitable gift is made personally, it results in a charitable donation tax credit which will reduce tax that was otherwise payable. Both on a personal level and corporate level, the limit on the amount of the charitable donation that may be claimed each year is 75% of net income and if the credit or deduction is not used, it can be carried forward for 5 years. Also, capital gains are eliminated for both personal and corporate gifts of public securities when the gift is made in kind.

A big difference between personal and corporate donations is that in the year of death, for an individual, the limit is 100% of net income and any excess can be carried back one year.

Private Corporations

Private corporations have a notional account called the capital dividend account (CDA). The CDA creates a unique financial planning opportunity for business owners when it comes to philanthropic tax planning and makes charitable giving through a corporation extremely attractive.

The CDA does not appear on the corporation's balance sheet and is a notional account that keeps track of the amounts that are eligible to be flowed to a shareholder on a tax-free basis and is a cumulative total that is often recorded in the notes to the financial statements. The CDA is a very important notional account as it allows a shareholder to withdraw funds on a tax-free basis from the corporation.

When a publicly traded security is sold by a corporation, 50% of the capital gain is taxable as income. The remaining 50% is not taxable and is credited to the CDA account.

Public Securities

When publicly traded securities with accrued gains are donated to a charity in kind, the CDA is credited with the non-taxable portion of the capital gain. Since donation of securities in kind to a charity eliminates 100% of the capital gain, 100% of the capital gain will be credited to the CDA account in this case. Therefore, by donating securities in kind to a charity, the entire capital gain can be withdrawn on a tax-free basis from the CDA account.

While the decision with regards to making a charitable gift is a personal decision and is based on the philanthropic intentions of the donor, the decision as to whether to make a gift personally or through a corporation often hinges on the tax benefits. Therefore, the ability to extract money on a tax-free basis from a corporation through the CDA, is a major consideration for shareholders as to where the source of the charitable gift should be.

Life Insurance

The proceeds of a corporately owned life insurance policy also flow through the CDA account and can be paid to the shareholders on a tax-free basis after deduction of the adjusted cost base of the policy.

The use of life insurance together with donation of securities in kind can allow business owners to multiply the results of their giving and minimize their estate tax liability as well as minimize their taxes during their lifetime.

Owning a corporate owned life insurance policy can help remove passive income inside the corporation by transferring savings to a tax-sheltered life insurance policy, where the funds can grow on a tax deferred basis during the lifetime of the business owner and on death, the death benefit minus the adjusted cost base of the policy can flow on a tax-free basis to the capital dividend account of the corporation and can be withdrawn tax free.

If you have not done so in that last few years, now is a good time to review your retirement and charitable giving strategies with a view to utilizing the latest strategies for minimizing passive income inside your corporation and maximizing the impact of your charitable giving and the legacy you intend to leave behind.

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