FIRST YORK

Deferring Capital Gains Tax Without "Grandfathering"

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We spend a lot of time making sure our clients and their advisors understand the opportunity to defer unnecessary tax by protecting "grandfathered" shares in share redemption arrangements. And rightly so; it is easy to lose these valuable benefits – or not be aware of them in the first place, so the time is well spent.

But what about the majority of shareholders of private companies who do not qualify for "grandfathering"? Are they stuck at paying tax at dividend or capital gains rates which might be as high as 36%?

Not necessarily.

If the shares of an operating company are owned by a holding company which is party to a share redemption agreement, the stop loss rules don't apply. The redemption results in a deemed dividend – declared to be a capital dividend – but there is no deemed capital gain and therefore no stop loss requiring half of the gain to be taxed as a regular dividend. This, of course, assumes that there is sufficient life insurance to fund the redemption.

Further, if the deceased owner of the holdco shares has bequeathed the holdco shares to his/her spouse, the spouse may then withdraw the capital dividend tax free from the holdco thereby realizing the entire gain tax free. We say "defer" but for the deceased person and his/her spouse, it is really "eliminate."

Why aren't more people talking about this and why doesn't everyone have his or her opco shares in a holdco? I'm sure there are good reasons for many, but I can't help thinking more business owners should be considering holdco's - not just for this reason, of course but also as they consider income tax, creditor proofing, capital gains and succession planning.