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Tax advantage in dual structure

Business owners can benefit from holding companies

Many small business owners establish holding companies to maximize their tax planning. There are a number potential benefits including tax efficiency, creditor protection, income splitting and succession planning.

Generally speaking, a holding company (Holdco) owns the shares of the business owner's operating company (Opco). The Opco carries on the active business and pays out its earnings to the Holdco as a dividend. The Holdco then uses the funds to hold diversified investments or pay out income.

Consider an incorporated business owner with significant retained earnings. The earnings can be moved over to the Holdco from the Opco on a tax-free basis via an inter-corporation dividend transfer. Although the Holdco assets are subject to the passive tax rate, they aren't taxed to the individual until distribution.

If a business owner has a very successful Opco, they'll want to take retained earnings out in order to avoid losing their small business status. That's because 90% of their assets must be used to earn income in the business. If there are excess funds in the Opco, they can be transferred to the Holdco. If necessary, the funds can be loaned back to the Opco on a secured basis.

The tax deferral benefits of Holdcos can be substantial. Let's examine a BC small business that earns $500,000 of income. The $500,000 would be subject to 13.5% active business income tax, leaving $432,500 that can be transferred to the Holdco for investment purposes. If an individual were to instead take the money out as a bonus, it would attract up to 43.7% tax; resulting in only $281,500 available for investment purposes.

Another benefit of the dividend transfer is potential creditor protection. Since the earnings are transferred to a separate entity, the funds are more difficult for creditors of the Opco to access. Even if the owner needs to move funds back to the Opco, the secured status of the funds creates a certain level of protection.

Holdcos can be a useful estate planning tool. Assets can be transferred to heirs through the use of a trust or they can be liquidated at death. This helps avoid the possibility of double taxation.

It's also possible to spread income across family members. Income can be paid out via dividends or salary if the family member is doing work for the company. This enables some of the earnings to be taxed in the hands of the family members, who are presumably in a lower tax bracket. One must be mindful of attribution rules though.

Under certain circumstances, Holdcos can help create an estate freeze, enabling accrual of the future growth of the corporation to heirs in a tax-deferred manner. If the estate freeze is done early enough, it can also significantly reduce the amount of taxes payable on death.

Holdcos are certainly not a tax haven but they offer excellent opportunities to qualified individuals. There

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are many intricacies to Holdcos, so it is imperative to seek advice from a tax professional.

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