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**Kim Inglis, BCom, CIM, PFP, FCSI, AIFP**

## **Tax planning key to small business success**

The use of Holdcos can help significantly

According to Industry Canada, only 51 percent of small and medium-sized businesses in Canada survive for five years. For those that endure, at least a portion of their success can be attributed to efficient tax planning through the use of holding companies.

A holding company (Holdco) is an intricate tax planning vehicle. A Holdco generally owns the shares of the business owner's operating company (Opco). The Opco carries on the active business and pays out its earnings as a dividend to the Holdco, which then uses the funds to hold diversified investments or pay out income.

There are several potential benefits to Holdcos including tax efficiency, creditor protection, income splitting and succession planning.

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

When an Opco is successful, the business owner will want to take retained earnings out in order to avoid losing their small business status, because 90% of the assets must be used to earn income in the business. Any excess funds in the Opco can be transferred to the Holdco and, if necessary, the

funds can be loaned back to the Opco on a secured basis.

Holdcos can also be used for tax deferral purposes. Consider an Ontario small business that earns \$500,000 of income and is subject to 15.5% active business income tax. The remaining amount of \$422,500 can be transferred to the Holdco for investment purposes. If an individual did not make use of a Holdco and were to instead take the money out as a bonus, it would attract up to 46.41% tax; resulting in only \$267,950 available for investment purposes.

Creditor protection is another benefit. Because earnings are transferred to a separate entity, the funds are more difficult for creditors of the Opco to access. Should the owner wish 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, thus helping to avoid the possibility of double taxation.

Income can also be spread across family members. If a family member is doing work for the company, income can be paid out through dividends or salary. This allows some of the earnings to be taxed in the hands of the family members, who are presumably in a lower tax

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bracket. Attribution rules must be taken into consideration 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.

The establishment of a Holdco requires careful deliberation, as there are a number of intricacies to consider. They are not suitable for all business

owners, so it is imperative to seek advice from a qualified tax professional.

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*Kim Inglis, CIM, PFP, FCSI, AIFP is an Investment Advisor & Portfolio Manager with Canaccord Wealth Management, a division of Canaccord Genuity Corp., Member – Canadian Investor Protection Fund. The views in this column are solely those of the author.*