

Protecting Business Profits – The Holding Company As “Banker”

Among their many profitable activities, banks are in the business of making commercial business loans. Banks are also very good at protecting the recovery of these loans by taking security that puts them ahead of all other creditors (with the exception of certain Crown claims). If their customer then has financial difficulties, the banks are usually able to collect their loan before anyone else is paid.

Entrepreneurs and owner/managers should take a page out of the banks’ playbook.

Annually, or even more frequently, dividends can be declared and paid by an operating company to a holding company, which has the effect of moving retained earnings up to the holding company. Properly structured, the dividends can be paid free of tax by the holding company. Because all or a part of these retained earnings are still needed to financing the working capital and growth of the operating company, the holding company can loan the money back to the operating company.

Just like the bank, the holding company may be issued security on the assets of the operating company. Although the bank will always ensure that its loan and security ranks first, by this means the entrepreneur and owner/manager can set it up so that he or she ranks second, ahead of the general creditors of the business.

It is important not to declare excessive dividends from the operating company which trigger the solvency tests in the corporate statutes. Excessive dividends trigger personal liability for directors, a result which defeats the whole purpose.

At modest cost, this can be set up immediately when the company is organized with a well-designed loan agreement between the holding company and the operating company, secured by a general security agreement for which a notice is registered in the *Personal Property Security Registry*. Thereafter, dividends need to be properly declared and recorded in the Minute Book, and preferably cheques should flow back and forth representing the dividend and advance of a new loan to the operating company.

If the business has been operating for some time and there is no holding company in place, then a holding company can be incorporated, and the shares of the operating company transferred to it with a tax roll-over so that there are no immediate capital gains tax consequences.

Many clients have several operating companies (example: a chain of retail outlets), all owned by a holding company. The structure then also becomes an effective way of channeling funds from one “cash rich” operating company to another in need of additional start-up or growth capital.

Note that if the operating company owns real estate, a registered Charge/Mortgage is necessary to have valid security on the real estate. However, in general it is also desirable to have the real estate owned by the holding company or another subsidiary so that the real estate is also removed

from the potential clutches of creditors. In the same way, the holding company can be used to hold other assets such as trademarks which, by their nature, do not carry significant risks and which are potentially valuable. For variety of reasons, be sure to maintain leases and licensing agreements when these assets are held in holding companies.

If this article is useful, you may also be interested in an article, "Creditors' Rights to Enforce Claims Against RRSPs and RRIFs". It is on our website, and a copy of this Article will be posted there as well for future reference.

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