What is a Holding Company Structure and Why is it so Popular?

Company owners and managers need to protect their business' assets. And over the years a number of strategies have been developed to help them do so. One of the most effective is to divide the business into several business entities all owned and controlled by a single holding company.

What is a holding company?

A holding company is a parent company—usually a corporation or LLC — whose purpose is to buy and control the ownership interests of other companies. The companies that are owned or controlled by a corporation holding company or an LLC holding company are called its subsidiaries. This structure is very popular and most states will have a number of holding companies and their subsidiaries formed in or operating in their states.

Types of holding companies

Many holding companies don't manufacture anything, sell any products or services, or conduct any other business operations. Their sole purpose is to hold the controlling stock or membership interests in other companies. This type of holding company is called a "pure" holding company.

Some holding companies, in addition to owning and controlling subsidiaries, have their own business operations. This type of holding company is called a "mixed" holding company.

Other types of holding companies include the "immediate" and "intermediate" holding companies, which are holding companies owned by other holding companies or larger businesses.

Holding company structure

In a typical holding company structure, the subsidiary companies manufacture, sell, or otherwise conduct business. These are called operating companies. Other subsidiary companies hold real estate, intellectual properties, vehicles, equipment, or anything else of value that is used by the operating companies.

The holding company can own 100% of the subsidiary, or it can own just enough stock or membership interests to control the subsidiary. Having control means it has enough stock or membership interests to ensure that a vote of owners will go its way. This can be 51%, or where there are many owners, it can be a much lower percentage.

Each subsidiary has its own management who runs the day-to-day business. The holding company's management is responsible for overseeing how the subsidiaries are run. They can elect and remove corporate directors or LLC managers, and can make major policy decisions like deciding to merge or dissolve. The people running the holding company do not participate in the operating companies' day-to-day decision making.

How is a holding company financed?

The holding company's management is also responsible for deciding where to invest its money. A pure holding company can obtain the funds to make its investments by selling equity interests in itself or its subsidiaries or by borrowing. It can also earn revenue from payments it receives from its subsidiaries in the form of dividends, distributions, interest payments, rents, and payments for back-office functions it may provide. A mixed holding company can earn revenue from its own business operations.

Holding company structure used by large enterprises

The holding company structure is used by businesses of all sizes and in all industries. Many of the best known publicly traded corporations are actually holding companies and many of the people buying their stock don't even realize they're investing in a holding company and not the operating company.

A holding company structure is popular with large enterprises with multiple business units. Take, for example, a large corporation that manufactures and sells several different consumer goods, including hair care products, skincare products, baby care products, and others. Rather than using one corporation with different divisions, this enterprise could be structured with one holding company and several subsidiaries.

Each business unit could be operated as a separate subsidiary in which the holding company owns a controlling interest. The company's intellectual properties, equipment, and real estate may also be placed in separate subsidiaries, with the operating companies paying to use the intellectual properties, lease the equipment, and rent its offices.

Holding company structure used by small enterprises

Holding companies can also be used by much smaller businesses—even by single entrepreneurs. Take, for example, a person who wants to buy an apartment building for the rental income. Two business entities could be formed: an LLC operating company that would own the apartment building and a LLC holding company that would own the LLC operating company.

Now let's say that our entrepreneur wants to buy a restaurant and a farm. A new subsidiary LLC can be formed for each new investment.

Advantages of the holding company structure

There are different reasons why holding companies are used. Below are a few:

1. Liability protection

Placing operating companies and the assets they use in separate entities provides a liability shield. The debts of each subsidiary belong to that subsidiary. A creditor of the subsidiary cannot reach the assets of the holding company or another subsidiary.

2. Control assets for less money

A holding company needs to control its subsidiaries but doesn't necessarily need to own all shares or membership interests. That allows the holding company to obtain control of another company and its assets at a lower cost than if it had acquired all of the subsidiary's ownership interests.

3. Lower debt financing costs

A holding company that has financial strength can often obtain loans for a lower interest rate than its operating companies could themselves, particularly where the business in need of capital is a startup or other venture considered a credit risk. The holding company can obtain the loan and distribute the funds to the subsidiary.

4. Foster innovation

Because operating companies are separate entities, there is less risk in investing in startups or other ventures that seem risky. Take, for example, a publicly traded company whose shareholders might object if the company veers from its core profitable businesses. However, if it is a holding company, the new venture could be set up in a subsidiary, thereby protecting the parent's assets.

5. Day-to-day management not required

A holding company can own businesses in a variety of unrelated industries. It doesn't matter if the owners and managers of the holding company don't know about those businesses because each subsidiary has its own management to run the day-to-day operations.

Disadvantages of the holding company structure

There are some drawbacks to using a holding company structure as well, including the following:

1. Formation and ongoing compliance costs

The holding company and each subsidiary require the payment of formation fees. There will also be, in most cases, annual report and franchise tax obligations. Each will also have to comply with the governing corporation or LLC statute and its individual governing documents. Using a single operating company avoids these additional per-entity compliance obligations and their associated costs.

2. Management challenges

As noted, a holding company does not have to own all of the subsidiaries' ownership interests. That can be both an advantage and a disadvantage. Where it does not own 100%, its management will have to deal with minority owners. Sometimes conflicts arise when the interests of the minority owners are different from those of the holding company.

The fact that the holding company's management does not have to be experts in the operating companies' businesses can also be both an advantage and a disadvantage. It can be a disadvantage because the holding company's management may be overseeing and making major policy decisions for businesses or industries in which they are not particularly familiar.

3. Complexity

The use of holding companies and subsidiaries adds an element of complexity not found in the single-entity structure. When a publicly traded corporation uses a holding company structure, for example, it can be very complex, with many subsidiaries to keep track of.

But even for much smaller enterprises, it is important to keep the records, assets, liabilities, and properties of each company separate from each other. Failure to do so can increase the risk of a court piercing the veil, and allowing a creditor to reach assets beyond the debtor subsidiary.

Creating a holding company structure

Once the decision has been made to use a holding company-operating company structure, the next question is how to do so? For a new business venture, this involves the need to form at least two business entities (one parent company and one subsidiary company) and maybe more.

For each entity to be formed there are several key decisions to be made including: (1) what type of business entity should be formed, (2) where should each entity be formed, (3) what name should be chosen for each entity, and (4) who should be the registered agent?

Conclusion

To sum it up, a holding company is a parent company that owns and controls other companies and in many cases does not produce any goods or services or conduct business operations of its own. The holding company structure is used by businesses of all sizes and in all industries and can be found in use in many states.

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