Selecting a Business Structure in Canada

1. Introduction

One of the first decisions to make when starting up a business is the legal form or structure your business should take.

Each business type has its own advantages and disadvantages which you will need to consider very carefully. Although it is possible to change the legal structure of your business as it expands and grows, it is easiest and most cost-effective to anticipate your future needs now and select the structure that will best meet those needs.

This article will concentrate on the three most common types of legal business structure: sole proprietorships, partnerships (general and limited) and corporations. Other possible structures include co-operatives and special incorporations for banks, insurance companies, trust and loan companies but these are highly specialized, fairly rare, and beyond the scope of this discussion.

In general, if you wish to be self-employed, your choices are either a sole proprietorship or an incorporated business. If you wish to co-own and run your business, your choices are either a partnership or a corporation. The structure you choose will be based on the tax implications, the level of liability you are willing to assume, your preferred jurisdiction of operation (provincial or federal) and other factors that will be discussed below.

A competent legal professional, in conjunction with an accountant, can help you examine all aspects of each type of business relative to your own situation. It is strongly recommended that you enlist their aid in choosing a business structure that is right for you. You are further advised to consult an insurance agent, to be sure that you have adequate life, disability and liability insurance and other insurance products relative to the type of business you choose.

2. Sole Proprietorships

A sole proprietorship is the simplest, most common and least expensive type of business structure. As a sole proprietor, you are considered to be self-employed. Although you may hire employees to assist you, you usually manage the business yourself. Under the law, you and your business are considered as one.

You are personally responsible for every aspect of your business, from securing capital to establishing and operating the business. While such autonomy and self-reliance may hold appeal, you are also personally responsible for all debts and obligations related to your business. You assume all risks, accept all profits and losses, and pay all taxes, including income tax, on your personal tax return. This personal responsibility means that, should a creditor have a claim against your business, he or she would have a right against both your business and personal assets. Furthermore, if a person should be harmed by your product or be injured on your premises, your business - and you personally - could be sued for damages. This is known as “unlimited liability” and it can be the biggest drawback to a sole proprietorship, especially if supplying goods or services to the general public or to a large market.

Choosing to operate as a sole proprietorship has important tax implications. Your net business income must be included as part of your personal income because you and your business are considered to be one and the same. If your business suffers a loss, you could deduct that loss from your other annual income. This would, in effect, lower your overall taxable income and reduce the amount of personal income tax you would have to pay. If your business earns a profit, this profit would be added to all other personal income and would be taxed at your personal income tax rate.

The only legal requirement in establishing a sole proprietorship is to obtain certain licences which may be required for certain types of business; for example, a Goods and Services Tax/Harmonized Sales Tax Account (GST/HST), municipal permits for operating a home-based business, etc. Licensing requirements vary by Province as well as according to the specific type and locality of the business’ operation.

If you plan to operate your sole proprietorship under a business name other than your own, you may be required to register your business name with the Province where you carry on business. Some Provinces also require that you conduct a search of your proposed business name. Whether or not this legal obligation exists in your particular Province, you are well advised to search your business name. If the name you want to use is identical or confusingly similar to another business name already registered, a search could help you avoid potential lawsuits.

PLEASE NOTE: The inclusion of any words other than your personal name in a business name will trigger a registration requirement; for instance, if “John Smith” is your name and it is used on its own as the business name, no business name registration is mandatory. Adding any word to the personal name will necessitate registration; “John Smith Computers” or "John Smith Consulting" must be registered.

Most Provinces require that a sole proprietor’s registered business address be located within that Province.

SOLE PROPRIETORSHIP	
ADVANTAGES	**DISADVANTAGES**
Personally responsible for all aspects of the business. Proprietor owns all business assets personally	Unlimited liability - if business and personal assets cannot cover debts, losses and other liabilities against the business, personal bankruptcy may have to be declared

Self-employed, not an employee of the business; autonomous decision-making	No ability to split income with family members through distribution of profits (dividends)
Easy and inexpensive to set up and maintain. Only one, personal income tax return to file. Can end the business at any time	Ownership cannot be transferred unless business assets are sold. The business ends when the sole proprietor dies
Minimal working capital required	Can be difficult to raise capital
All profits go to owner. Any losses can be deducted from other sources of personal income, which lowers the overall taxable income and amount of income tax to be paid	Any profits are taxed at the owner's personal income tax rate, which is typically higher than a corporate tax rate

Consider a sole proprietorship if your business will have financial losses which can be applied against other personal income, or if your business will earn a profit and you do not foresee significant liability concerns.

3. Partnerships

A partnership is a business structure that is based on two or more persons who pool their resources to co-own a business and to share in the profits which are generated. Partners may employ others to help run the business, but they usually have a hand in its operation or management themselves, and they are considered to be self-employed for tax purposes. Partnerships are similar to sole proprietorships in that the business owners personally own all the assets of the partnership and are personally responsible for any liabilities that the partnership may incur; i.e., they usually have unlimited liability.

Partnerships may have to obtain certain licences which may be required for certain types of business; for example, a Goods and Services Tax/Harmonized Sales Tax Account (GST/HST), municipal permits for operating a home-based business, etc. Licensing requirements vary by Province as well as according to the specific type and locality of the business' operation.

If you plan to operate your partnership under a business name other than the exact names of the partners, you may be obliged to register your business name with the Province where you carry on business. Some Provinces further require that you conduct a search of your proposed business name. Whether or not this legal obligation exists in your particular Province, you are well advised to search your business name. If the name you want to use is identical to, or confusingly similar with another business name already registered, a search could help you avoid potential lawsuits.

In order to establish the terms of a partnership, define the rights and responsibilities of the individual partners and to protect them in the event of a disagreement or dissolution of the partnership, it is recommended that a partnership agreement be drafted by a lawyer.

In most jurisdictions, there are two types of partnership: general and limited.

General Partnerships

In a general partnership, two or more owners share in the management of the business. All partners own the business and they are jointly and severally responsible for the liabilities of the partnership up to the total value of their personal assets. This means that, whether the partners act individually or in tandem, the responsibility for liability lies with each partner individually and with all partners jointly. Each partner is therefore fully responsible for the acts of every other partner and for the acts of the partnership as a whole.

Although there are no formal filing requirements for general partnerships, they are governed by specific Provincial legislation which sets out rules governing partnership obligations in relation to third parties and rules governing obligations between the partners themselves. A general partnership is created when two or more persons carry on business in common with the anticipation of profit. Many individuals are not aware that the partnership legislation applies, even if no formal filing has been completed. You are advised to seek legal advice from a lawyer if you anticipate conducting business jointly with others.

Limited Partnerships

In a limited partnership, all the partners own the assets of the business but there may be a combination of general and limited partners. General partners are involved in managing and operating the business. They are fully liable for the debts and obligations of the business, but they may be entitled to a greater share of the profits. Limited partners are not involved in managing the business. Their sole contribution is capital; as a result, they enjoy limited liability in that they cannot be held responsible for more than the amount of capital they contributed.

Limited partnership interests can be transferred and, in this respect, limited partnerships are similar to corporations whose structure provides for the transfer of shares. This allows the partnership to evolve and continue in the event that one or more partners should leave.

Limited partnerships are created by statute. In most cases, a “Partnership Declaration” must be filed to establish the Limited Partnership.

PARTNERSHIP	
ADVANTAGES	**DISADVANTAGES**
Partners own all business assets personally	Unlimited liability - if business and personal assets cannot cover debts, losses and other liabilities against the business, personal bankruptcy may have to be declared. (Except in the case of limited partners who are only required to cover an amount equal to their capital contribution)
Managerial/operational duties shared	Divided authority; decision-making by committee

Limited regulation	Can be difficult to find compatible partners; partners can legally bind each other without prior approval
Separate accounting records for the business, but each partner has only one, personal income tax return to file. Can end the business at any time	Ownership can generally not be transferred unless business assets are sold. The business ends when the partners die. Limited partnership interests can be transferred, similar to shares
Less expensive to establish than a corporation	Can be more expensive to establish than a sole proprietorship if a partnership agreement is prepared
Several sources of initial investment capital, from partners	Can be difficult to raise significant capital
All profits to be shared by partners. Any losses can be deducted from other sources of personal income, which lowers the overall taxable income and amount of income tax to be paid	All profits are taxed at the individual partners' personal income tax rate, which is typically higher than a corporate tax rate

Consider a partnership if you would like to share the management and operation of your business, as well as the profits, with one or more partners and you do not foresee significant liability concerns.

From a tax standpoint, a partnership might be recommended if you expect your business to lose money in its early years and if you and your partners can apply that business loss against other taxable income.

4. Corporations

Whether you are just starting a business or you already operate as a sole proprietorship or in a partnership, incorporation is an option worth considering. Incorporation is more complicated, expensive, and time-consuming to establish and maintain; however, it offers several key advantages that the other forms of business do not.

The corporation's greatest advantage is that it allows for limited liability which generally limits personal liability to a maximum amount equal to the amount of share capital each owner (shareholder) has contributed to the business. Unlike sole proprietorships and partnerships, where all the personal assets of the owners can be seized to pay for their debts, obligations and liabilities, as the owner of a corporation, you generally cannot be held personally responsible for the company's debts and other liabilities.

A corporation is treated as a separate legal person under the law. It has the same rights as an individual, in that it can own property, investments, carry on business, borrow money, incur liabilities and debt, sue and be sued, etc. You must think of the corporation as an independent person, separate from its owners. The corporation must have its own separate bank account, and the corporation's assets should not be mixed with the personal assets of its owners. The corporation must maintain its own set of financial/accounting books or records and must file corporate tax returns that are separate from the personal income tax returns of its owners.

While many corporations are set up and run by one person only, there are several types of positions associated with all corporations. Shareholders are the owners of the corporation; they may receive distributions of corporate profits in the form of dividends, and they split the assets of the corporation upon dissolution. Shareholders elect directors whose job is to oversee the operation of the corporation for the benefit of the shareholders. The directors approve financial statements and make many important decisions regarding the operation of the corporation, including the appointment of officers who manage the Corporation's day to day operations. Officers are usually given specific titles, such as President or Secretary. One person can usually hold all of the different positions listed above; however, all corporations must appoint one or more individuals to these positions.

The legal element of a corporation's full legal name ("Limited", "Incorporated", "Corporation", etc.) indicates its limited liability status and it must be included as part of the corporation's name. For some incorporated businesses, their ability to use this legal element or corporate identifier also serves to attract new business, since incorporated companies are perceived to be more stable and reliable. Also, certain companies may choose to retain only those contractors whose business is incorporated, because of liability concerns.

Businesses can be incorporated either federally or provincially. Please note that a federally incorporated company will still need to obtain additional extra-provincial registrations in each Province in which it operates. If your company is incorporated provincially but you decide to operate it in multiple provinces at a later date, you must obtain an extra-provincial licence from every other Province in which you wish to carry on business.

Because a corporation is a separate legal entity, it does not rely on its membership for its continued existence. A corporation will continue to exist even if its shareholders die or leave the business, or if the ownership of the business changes.

Corporations are owned by shareholders. Even if you are the only person who owns your incorporated business, you are still considered to be a shareholder. In general, it is easy for shares to be bought and sold. By issuing and selling shares, an incorporated company can raise money more easily than sole proprietorships or partnerships, which generally rely on capital supplied by their owners.

This ability to raise equity capital is a huge advantage because, in general, equity capital does not have to be repaid and it incurs no interest charges. Keep in mind that the issuance of shares can reduce your percentage of ownership in the company. For example, if you own 100 shares and you issue another 100 shares to another shareholder, your percentage of ownership of the company has been reduced from 100% to 50%.

There are several tax advantages to incorporation. Given their complexity, you should consult with an accountant or lawyer to understand them fully, but essentially they include income splitting, tax deferral, annual tax credits and a capital gains exemption.

- Income splitting allows you to name your spouse and/or children as shareholders of the company. By issuing them dividends, you can redistribute income from high-income family members to lower-income members who are taxed at a lower rate.
- With an incorporated business, you can determine when you receive your income. You can structure your payroll, dividends and/or bonuses so that you receive income at a time when you will pay less tax.
- Certain Canadian-owned private corporations qualify for the "Small Business Deduction" which is an annual tax credit that is applied against the corporation's income. This tax credit can significantly reduce the amount of corporate tax payable. If your corporation qualifies for the deduction, it will usually result in a much lower tax rate than the rate that would apply to equivalent personal income earned in a sole proprietorship or partnership.
- If you own an incorporated business, you may be eligible for a $500,000 capital gains exemption on the sale of that business. To qualify, the shares must be of a Canadian-controlled private corporation, at least 90% of whose assets are used in an active business conducted in Canada or a holding company which owns such shares. In the case of shares that qualify, the business owner may sell them and the first $500,000 of capital gains will be exempt from tax. This exemption applies to the individual, not the corporation and, once the owner has claimed the $500,000 exemption, it will no longer be available on a sale of other qualifying shares.

Despite the considerable benefits of incorporating your business, you should be aware that there are also some drawbacks.

You will be required to file two or three tax returns each year: one for your personal income and a separate one or two for your corporation's income. This will mean extra accounting fees and more time in bookkeeping. Note also that corporate losses cannot be deducted from your personal income, as they can with a sole proprietorship or partnership.

Because corporations are regulated and monitored by the government, there is additional paperwork involved in their maintenance. In addition to extra bookkeeping, a minute book containing corporate bylaws, meeting minutes or resolutions, registers and ledgers must be maintained.

When losses arise in a corporation, they can only be offset against the earnings in that corporation – they cannot be transferred to the shareholders. This phenomenon is known as "trapped losses". Owners of unincorporated businesses are allowed to use their business losses against other sources of personal income or against future earnings. For this reason, it usually does not make sense to incorporate a business that is not operating at the break-even point, unless limited liability, as opposed to tax implications, is the overriding factor in favour of incorporation.

There is the also possibility of higher taxation for incorporated businesses by double taxation. Corporate income is taxed at the corporate level when it is earned by the corporation, and it is taxed again at the personal level when it is removed from the corporation as a dividend. This effectively means that this income will be taxed twice.

ADVANTAGES	DISADVANTAGES
Limited personal liability. The owner and the corporation are considered to be separate entities	If owner must post a personal guarantee to secure financing, owner will still be held personally liable. Shareholders may be held legally responsible for liabilities in certain circumstances
Continuance. Corporation will live on despite change of management, demise of officers	Administrative paperwork required to end the business
Shares can be issued to raise equity capital for expansion, etc.	Dilution of ownership through selling of shares
Tax advantages: income sharing, tax deferral, possible tax credits, capital gains exemption on sale of business	Not eligible for personal tax credits. Trapped losses, potential of double taxation
Sharing of responsibilities related to business operation and management	More costly to establish and maintain than other forms of business; two or three income tax returns required, extra bookkeeping and record keeping

Consider incorporating your business if would like to limit your liability or if will benefit from corporate tax advantages.

7. COMPARATIVE CHART OF BUSINESS STRUCTURE TYPES

CHARACTERISTIC	SOLE PROPRIETORSHIP	GENERAL PARTNERSHIP	LIMITED PARTNERSHIP	INCORPORATION
Liability	Unlimited	Unlimited	Unlimited/limited	Limited
Continuance	No	No	No	Yes
Cost of set-up	Least expensive	Moderate	Moderate	Expensive
Accounting fees	Minimal	Moderate	Moderate	Moderate/ expensive;
Bookkeeping/ Records	Minimal	Moderate	Moderate/ extensive	Extensive
Regulation	Little	Moderate	Moderate	High
Jurisdiction	Provincial	Provincial;	Provincial	Provincial and/or Federal
Start-up capital	Personal savings, loan, etc.	Combined personal resources	Combined personal resources	Personal savings, loan, Venture or Equity capital
Raising capital	Difficult	Difficult	Less difficult	Less difficult
Tax filings	Personal only	Personal only	Personal only	Personal and corporate

**Select the legal business structure that best suits your needs…
for today and tomorrow.**