

LEGAL MATTERS

To Incorporate or Not to Incorporate?

If you are the sole proprietor of your business, you may want to consider two other options. There are legal as well as tax advantages and disadvantages to each type.



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Sole proprietorships

An individual who owns and conducts business in his/her own personal capacity is called a sole proprietorship. It's not a separate legal entity and any debts or liabilities incurred by the business are debts or liabilities of that individual. A sole proprietor owns the assets of the business. The income or loss of a sole proprietorship is combined with the other earnings of the individual for income tax purposes.

The advantages of a sole proprietorship are low start-up costs, and ease of decision-making. A major disadvantage is that the sole proprietor is exposed to unlimited liability and may not be able to take advantage of certain tax planning options available to partnerships or corporations.

Partnerships

When two or more people start a business, they often do so by way of a partnership. There are two types of partnerships: general and limited. In a general partnership, the liabilities and debts of the partnership flow through to each of the partners. The partners also share ownership of assets and authority in running the business. If a partnership is not able to pay its debts, creditors may have access to the personal assets of each of the partners.

A limited partnership consists of one or more general partners and one or more limited partners. The general partners are personally liable for the partnership debts. The limited partners contribute capital and share in the profits and the losses of the business. Limited partners must not be involved in managing the business and cannot be liable for more than the amount of capital they have contributed.

As with a sole proprietorship, start-up costs are lower than those involved in setting up a corporation. To establish the terms of the partnership and to protect yourself in the event of a disagreement, a partnership agreement should be drawn up with the help of legal counsel.

Corporations

A corporation is a separate legal entity from its shareholders. Generally, a corporation has the same rights and obligations under Canadian law as a natural person. As such, the corporation will hold the assets of the business and assume responsibility for any debts and liabilities of the business. As a separate legal entity, a corporation is taxed separately from its shareholders and has its own tax rates.

The main benefit that incorporation has over sole proprietorships and partnerships is the limitation of liability. Except in exceptional circumstances, a shareholder of a corporation does not have liability for corporate acts. Since a corporation is a separate legal entity, shareholders of a corporation do not have personal liability to creditors of the corporation. Note, however, that directors of a corporation may face certain statutory and common law liabilities.

There are some tax benefits that may be applicable to certain Canadian corporations. Other benefits are that ownership of the corporation is transferable and the corporation continues to exist even if there is a reorganization in shareholdings. Corporate property is not affected by the death of a shareholder, though the shares of the corporation may be redistributed among the remaining shareholders or the estate/beneficiaries of the deceased shareholder.

Another thing to remember is that corporations are highly regulated compared to sole proprietorships or partnerships. While the start-up costs of forming a corporation are higher, the tax advantages of incorporating will usually outweigh any initial costs. There are annual filings required and other annual corporate documentation that should be completed for a corporation. The fees to do so are not usually substantial, and any annual filings or other documents can be prepared easily with the help of legal counsel.

Where two or more shareholders are involved, it is important to establish the terms governing the relationship between shareholders of the corporation, and to protect yourself in the event of a disagreement among the shareholders. A shareholders' agreement should be drawn up with the help of legal counsel.

Where to go from here?

Whether you have been carrying on business for three months or three years, you may want to consider incorporating a company to address some of the considerations discussed above. There are several significant tax benefits of incorporation for a small, active Canadian business, which can be discussed with your professional advisors. While tax advice from an accountant is necessary and recommended, sound legal advice is indispensable.

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