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METHODS OF CARRYING ON BUSINESS IN CANADA

One of the most important decisions to be made when entering into a new business venture is the vehicle to be used to carry on the business. The choice you make will have a significant impact on the liabilities you are exposed to, the ease and flexibility of financing, the amount of income tax you pay, the rules and regulations you are governed by, and the amount of time, energy and money you are required to expend in establishing your business.

There are numerous types of business entities which can be used to carry on business, but this short paper will briefly outline the three most popular methods: (i) sole proprietorship; (ii) partnership; and, (iii) corporation. This discussion is not meant to be exhaustive.

1. Sole Proprietorship:

(a) Description and Establishment

A sole proprietorship is a business which is owned and operated by **one** individual without the use of other forms of business organizations or the participation of other individuals, except employees and other third parties without any ownership interest in the business. A sole proprietor receives all of the benefits which flow from the business. A sole proprietor cannot be employed by the business, although the business can employ others. Due to the limited number of legal requirements, a sole proprietorship is the business vehicle that initially requires the least expenditure of time, energy and money to establish. If a sole proprietor carries on business under a name other than their own name, he or she must register such trade name under the *Business Names Act* (Ontario) or such other corresponding legislation in other Provinces. If a sole proprietor establishes a business in his/her own name, without adding any other words, it is not necessary to register the business name. Business name registrations are valid for five years at which time a renewal is required. Prior searches are recommended to ensure that a sole proprietor does not attempt to use a business name which is the same as or too similar to a name already being used by another business in the Province. Industry or Province specific licensing may also be required depending on the nature of the business.

(b) Liability

Personal liability for a sole proprietor is unlimited. As a result, a sole proprietor is personally responsible for all tortious acts, debts and contractual obligations relating to their business. For example, a creditor with a claim against a sole proprietor would normally have a right against all of his or her assets, whether business or personal. Many insurance companies offer personal liability coverage for entrepreneurs, allowing for some risk management of liabilities. In addition, well-negotiated and drafted agreements may also limit some trade related liabilities.

(c) Financing

A sole proprietorship is generally more difficult to finance, depending mainly on the personal credit and financial resources of the owner. This is the least flexible business structure from a financing point of view. Only debt financing may be taken on, since no equity investments can be taken from any other sources.

(d) Taxation

With respect to taxation, all income or losses of a sole proprietorship must be included with the sole proprietor's income or losses from all other sources in one year. The aggregate is subject to federal and provincial income tax. Pursuant to Canadian federal and provincial income tax laws, individuals are taxed at progressive rates.

If an individual expects a new business to lose money in its first few years and the individual has income coming in from other sources, he or she may wish to choose a sole proprietorship as the entity for carrying on business (unless he/she intends on carrying on business with one or more additional parties in which case a partnership may be the appropriate legal entity) as the losses from the new business can be used to offset income received from other sources.

2. Partnership:

(a) Description and Establishment

A partnership exists when **two or more** persons, whether individuals or corporations (or a combination of both), carry on business in common with a view to profit. Each of the individual partners has ownership of the business assets, is responsible for the liabilities of the partnership, and has authority to run the business. Individual partners cannot be employed by the partnership although the partnership can employ others. Partnerships may exist in one or two forms, a general partnership or a limited partnership. In Ontario both types of partnerships are governed by statute. The names and pertinent information of all the partners must be registered with the Ministry of Government Services which registration must be renewed every five years. If a partnership fails to register, the partnership and the individual partners cannot maintain a proceeding in a court in Ontario. In order to establish the terms of the business and to protect partners in the event of disagreement or dissolution of the partnership, a partnership agreement should be drawn up with the assistance of a lawyer.

(b) Liability

With respect to personal liability, similar to a sole proprietorship, a partnership is not a separate legal entity from the partners who make up the partnership. Each partner in a partnership is an agent of the partnership and of the other partners, and therefore the actions of one partner binds each of the other partners. Each partner is also jointly and severally liable, with all of the other partners to the full extent of his or her personal assets, for the obligations of the partnership which were incurred or tortious acts committed while the individual was a partner. Partners also have a duty to one another to be loyal and act in good faith and cannot compete with the partnership.

In a limited partnership, the liability of the general partner(s) is unlimited, and the liability of the limited partner(s) is limited to the amount invested in the limited partnership. Limited partners are sometimes referred to as "silent partners" who contribute capital, but do not share in the management or liabilities of the partnership. Many insurance companies offer personal liability coverage for partnerships, allowing for some risk management of liabilities. In addition, well-negotiated and drafted agreements may also limit some trade related liabilities.

(c) Financing

As in a sole proprietorship, a partnership is generally more difficult to finance, depending mainly on the personal credit and financial resources of the partners. However, since there is the ability to have limited partners, this allows for an “equity” type of investment.

(d) Taxation

For income tax purposes, a partnership is treated as a conduit through which income is passed to the individual partners. A partnership does not pay income tax, as the individual partners pay income tax on all income earned from the partnership.

If an individual expects a new business to lose money in its first few years and the individual has income coming in from other sources, he or she may wish to choose a partnership as the entity for carrying on business, as the losses from the new business can be used to offset income received from other sources.

3. Corporation:

(a) Description and Establishment

A corporation is a legal entity separate in law from its owners (i.e. the shareholders), and is created under provincial or federal statute. It is possible for an individual to be both an employee and a shareholder of a corporation. A corporation with share capital is the most frequently used method of carrying on business in Canada.

A corporation is created by registration of Articles of Incorporation under provincial or federal statute. The government fees associated with the incorporation of an Ontario corporation are approximately four hundred dollars excluding legal fees. Once incorporated, a corporation can own property, carry on business, possess rights and incur liabilities. A corporation carries on business under its own name and has a perpetual existence. That is, a corporation is dissolved only when a special majority of the shareholders resolve that it should be dissolved. If a corporation carries on business under a name other than its corporate name (i.e. ABC Inc.), it must register such name under the *Business Names Act* (Ontario) or such other corresponding legislation in other Provinces.

Shareholders of a corporation obtain shares in the corporation by providing the corporation with money, prior services or property in exchange for their shares. A corporation's shareholders do not own the business or the property belonging to the corporation, and the rights and liabilities of the corporation are not the rights and liabilities of its shareholders. Shareholders are responsible for appointing directors who manage and supervise the management of the business and affairs of the corporation. In order to be a director of a corporation, an individual must be at least eighteen years of age, of sound mind and not bankrupt. The majority of directors of an Ontario corporation must also be resident Canadians.

(b) Liability

Probably one of the most beneficial aspects of a corporation is the limited liability of its shareholders. Shareholders have limited liability because their liability in connection with the property or business owned by the corporation is limited to the value of the assets they have transferred to the corporation in exchange for their shares. A shareholder’s liability to creditors of a corporation, in most instances, is therefore limited to the amount of his/her investment in the shares of the corporation. There are times however, when a shareholder is required to personally guarantee a corporation’s debts or when he/she would be liable for the acts of a corporation (when the courts "lifts the corporate veil" contending the individual is the "alter ego" of the corporation). There are also significant potential personal liabilities associated with being a director of a corporation which individuals should be aware of, including without limitation: unpaid employee wages (to a maximum of six (6) months), unremitted GST, PST and corporate income tax.

(c) Financing

A corporation is the most flexible structure from a financing perspective. Various types of debt and equity products are available including unsecured debt, secured debt, mezzanine or sub-debt, equity based on preferred shares and equity tied to common shares. In addition, corporations may make "offerings" to the public for capital. However, any offering of securities to the public also requires compliance with securities laws and regulations.

(d) Taxation

A corporation's income is determined and taxed separately from that of its shareholders. A corporation's after-tax income can be paid to its shareholders by the declaration of a dividend authorized by the directors. The dividend is income in the hands of shareholders and therefore taxable as such at the personal level.

Corporations can gain advantages from a tax perspective in several ways. First, corporations are eligible for several types of tax credits and business deductions. Second, a corporation can reduce taxes payable by paying income out to the owners as salary rather than dividends. The corporation can deduct the salaries from its income in determining its income subject to tax. Lastly, there is a tax deferral created by leaving funds in the corporation.

Conclusion:

Based on the significant implications in choosing an appropriate business vehicle, an accountant and a lawyer should be consulted prior to the structure being formalized.

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