

Choosing the right business structure

Of all the decisions to be made when starting a business, one of the most important is the type of legal structure the business owner selects for their enterprise. This decision impacts both the owner and the business in many ways: tax liabilities, the administrative complexities, the management of debt, and the extent of personal legal liability for the owner.

Choosing the legal structure is one of the first steps in starting up a business. The structure that makes the most sense will depend on individual circumstances. Each business structure has advantages and disadvantages that will be integral to the personal and business success of the business owner.

The business structure influences everything from day-to-day operations, to taxes, to the amount of personal assets at risk. The business owner should choose a structure that gives the right balance of legal protection and benefits.

Choosing an appropriate business structure that meets your needs is an important decision

There are four types of business structures: sole proprietorship, partnership, corporation and co-operative

Sole proprietorship

A sole proprietorship is the simplest way to organize a business. It is the least expensive to set up and register and the easiest to manage, due to less onerous government reporting requirements. In this business structure, the business assets are owned personally, such that the business owner has complete control over business decisions and receives all of the profits earned by the business.

In this structure, the business owner is usually considered to be self-employed. Little or no capital is required to set up the business, but raising capital later may be difficult due to the inability to issue shares in exchange for capital.

As a sole owner, the business owner is personally responsible for all debts and obligations related to the business; this is referred to as unlimited liability. This means that the owner's business and other personal assets are subject to claims by creditors to satisfy any unpaid debts.



All profits go directly to the business owner, so net business income is taxed as personal income. The business owner must file a personal tax return to report all business income or losses. If the business is performing poorly, business losses can be deducted against other income, such as investment or rental income.

In a sole proprietorship, the owner generally performs all of the functions required to set up and manage the business. It may be difficult to attract other employees, and when the business owner wants to retire it may be difficult to ensure the continuity of the business.

Partnership

A partnership is a non-incorporated business established by two or more individuals to combine their resources and share in the profits and expenses. This type of business organization is usually easy to set up and manage, but it is highly recommended that a written partnership agreement is drafted at the beginning of the relationship between partners to address operating procedures. A partnership agreement should be reviewed regularly and updated as circumstances require.

This business structure combines the financial resources and the unique skillsets of the business partners. While this means there are “more hands on deck” to control and manage the

business, the division of authority may potentially lead to disagreements or conflict between partners when making important business decisions.

The written partnership agreement is a useful tool for managing the business effectively and minimizing conflict. This legal agreement should clearly define the terms of the business, provide a process for conflict resolution, and state how profits or losses will be shared. It should also describe the steps and outcome on the dissolution of the business, as well as on the death or incapacity of one of the partners. It is important to seek the advice of a legal professional when drawing up a partnership agreement and ensure the protection of the individual interests of the partners through independent legal advice.

There are two types of partnership: general and limited. The extent of personal liability for each partner is dependent on the type of partnership. In a general partnership, each partner is jointly and personally liable for all the debts and obligations of the partnership. This is known as unlimited liability. In a limited partnership, a partner can contribute to the business without being involved in its day-to-day operations, and so is not personally liable for the debts of the business. A limited liability partnership is most commonly used by professionals such as lawyers, accountants and doctors.

The partners of the business will share in all the profits and losses of the business (unless otherwise provided in a partnership agreement), and these will flow to the individual partners. The individual partners will report their share of the net income or loss on their personal income tax return.

It is difficult to raise additional capital for the business from third parties since there are no shares to exchange for capital. Such capital may need to be sourced from operating profits or the partners' own personal assets.

Compared to a sole proprietorship, business continuity in a partnership is easier as it is less reliant on one individual. Hence, it is important that a partnership agreement is in place to describe how to deal with the exit of one of the partners from the partnership.

If you are considering setting up your business as a partnership or investing in a partnership, you should consult with legal and tax professionals for advice.

Corporation

The most common type of business structure is a corporation. Corporations are complex, with more onerous reporting requirements, and thus tend to be expensive to set up and operate. Depending on where a corporation operates, additional federal and/or provincial incorporations or registrations may be required, resulting in more legal and accounting fees. Corporations are heavily regulated, which leads to a number of reporting and disclosure requirements such as detailed financial statements and tax filings. This type of business organization is a legal entity that is governed by its incorporating document – the Articles of Incorporation. It is separate from its shareholders but controlled by the shareholders through directors of the business elected by them. As a separate legal entity, a corporation can borrow or lend on its own account (subject to the articles), incur legal liability and continue operating as a business on its own without relying on any one individual.

A significant advantage for the shareholders of a corporation is limited liability. The shareholders are not personally liable for any of the debts and obligations of the corporation, and their personal assets are protected from creditors unless the shareholder has made a personal guarantee for a loan

to the corporation. Shareholders can benefit from reduced tax rates for business income received by the corporation, a possible tax deferral, and an exemption from capital gains tax when the shares of certain types of active businesses are sold. Shareholders of a corporation can also benefit from more sophisticated retirement planning, including the use of Individual Pension Plans, Retirement Compensation Arrangements and estate freezes.

A corporation is required to file an annual corporate tax return, in addition to the personal tax returns of the shareholders. Unlike a proprietorship or partnership, corporate losses cannot be used to offset income on a shareholder's personal tax return.

The shares and ownership of a corporation can be easily exchanged with the sale and purchase of corporate shares, which is advantageous for the continuity of a business structured as a corporation. This exchange makes it easier to raise capital for the business and also will not impact the continued operation of the corporate business during the exchange.

Finally, a corporation can be public – that is, traded on a stock exchange – or private. It may also be classified as a professional corporation, which is most often the business structure of choice for doctors, dentists and lawyers.

It is advisable to seek professional tax and legal advice before incorporating a business.

Co-operative

A co-operative is owned by an association of people or businesses that pool their resources to meet a common need. A co-operative offers democratic control where each member gets one vote. Like a corporation, it is considered a legal entity, which limits the personal liability of its members. This also allows the organization to acquire assets, go into debt and enter into contracts.

Co-operatives exist in a variety of economic sectors, such as agriculture, food, social services (e.g., health care, housing), retail and wholesale, fishing, energy, recreational services, and finance (including insurance). It is the least common form of business structure, but can be appropriate for a group of individuals or businesses who pool their resources providing the sale or delivery of products or services, or employment.

Changing the business structure

There may be circumstances, personal or business-related, when it may be appropriate to change the business structure of a company. Some conversions may be simple, such as moving from a sole proprietorship to a partnership, but others may be more complex and costly, such as transitioning from a proprietorship or partnership to a corporation. You may consider changing your business structure as your business develops and circumstances change, but you should seek professional legal and tax advice to determine if it is beneficial and how to do it effectively.

Conclusion

Choosing an appropriate business structure that meets your needs is an important decision and will depend on your personal and business situations. Working with experienced advisors, such as a legal professional and a tax accountant, can help you identify and set up the business structure that is most appropriate for you and your business now, and in the future as your business develops.



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