SWRBOT
SURREY & WHITE ROCK BOARD OF TRADE

# Forms of Business Organizations

One of the hardest major decisions you will have to make as you start to grow your new business is the form of legal entity it will make. To a large degree, this decision may be dedicated by the way you have organized your operations and whether you intend to work on your own or in conjunction with others.

The form of entity you choose can have a significant impact on the way you are protected under the law and the way you are affected by income tax rules and regulations. There are three basic forms of business organizations. Each has its own benefits and drawbacks and is treated differently for legal and tax purposes.

## *Sole Proprietorship*

A sole proprietorship or simply proprietorship is typically a business owned and operated by one individual. A sole propreitorship is not considered to be a legal entity under the law but rather is an extention of the individual who owns it. The owner has possessions of the business assets and is directly responsible for the debts and other liabilities incurred by the business. If the business fails and becomes insolvent, creditors have recourse to all the assets owned by the proprietor.

The income or loss of a sole proprietorship is combined with the other earnings of an individual for income tax purposes. There can be a tax advantage during start-up if the business has losses, but it is normally a disadvantage once earnings exceed the amount needed for the propeitor's personal living expenses.

A sole proprietorship is perhaps the easiest form of business to own and operate because it does not require any specific legal organization except, of course, the normal requirements such as licenses or permits.

| Advantages | Disadvantages |
|---|---|
| ➢ Low start-up cost<br>➢ Creates freedom from regulation<br>➢ Owner in direct control of decision making<br>➢ All profits to owner | ➢ Unlimited liability<br>➢ Lack of continuity in business organization in absence of owner<br>➢ Difficulty of raising capital |

## *Partnership*

A general partnership is when two or more individuals join together to run a business enterprise. Each of the individual partners has ownership of partnership assets and responsibility for liabilities, as well as authority in running the business. The authority of the partners, and the way in which profits or losses are to be shared, can be modified by the partnership agreement. The responsibility for liabilities can also be modified by agreement among the partners, but partnership creditors typically have recourse to the personal assets of each of the partners for settlement for their accounts.

The rights, responsibilities and obligations of general partners are typically detailed in a "*Partnership Agreement.*" It is a good idea to have such an agreement for any partnership.

A partnership does not pay income tax. The information from the financial statements of the partnership is combined with the personal income of each partner to determine his or her overall tax liability.

| Advantages | Disadvantages |
|---|---|
| ➢ Ease of formation<br>➢ Low start-up cost<br>➢ Additional sources of investment capital<br>➢ Limited regulation<br>➢ Broader management base | ➢ Unlimited liability<br>➢ Lack of continuity<br>➢ Divided authority<br>➢ Difficulty in raising additional capital<br>➢ Hard to find suitable partners<br>➢ Possible development of conflict between partners |

## *Corporation*

A corporation is a separate legal entity, which exists under the authority granted by either federal or provincial. A corporation has substantially all the legal rights of an individual and is responsible for its own debts. It must also file income tax returns and pay taxes on income it derives from its operations. Typically, the owners or shareholders of a corporation are protected from the creditors of the business. However, when a corporation is small, creditors often require personal guarantees of the principal owners before extending credit. The legal protection afforded the owners of a corporation can far outweigh the additional expense of starting and administering it.

A corporation must adopt and file articles of incorporation or by-laws, which can govern its rights and obligations to its shareholders, directors and officers. Annual reports must be filed with the registrar of companies of reach year and on time.

A corporation must file annual federal income tax returns with Canada Customs and Revenue Agency ("CCRA") and provincial returns in Ontario, Quebec and Alberta if it does business in these provinces. Any elections made in a corporation's initial tax return can have a significant impact on how the business is taxed in the future.

Incorporating a business allows several other advantages such as the ease of bringing in additional capital through the sale of equity (i.e. shares) or allowing an individual to sell or transfer in the business. It also provides for business continuity when the original owners choose to retire or sell their interest. Incorporation can mean a significant deferral of income taxes, since the small business tax rate is much lower than the top personal rates. If many also allow opportunities for income splitting with family members to reduce overall income taxes of a family.

Should you decide to incorporate your business venture, you should seek the advice of competent legal counsel and a chartered accountant.

| Advantages | Disadvantages |
|---|---|
| ➢ Limited liability<br>➢ Ownership is transferable<br>➢ Continuous existence<br>➢ Separate legal entity<br>➢ Possible tax advantage (i.e. lower small business tax, shared family ownership)<br>➢ Easier to raise capital | ➢ Closely regulated<br>➢ Most expensive form to organize<br>➢ Chartered restrictions<br>➢ Extensive record keeping necessary |