

Structuring Your New Business

by Mike Pendrith

Frequently I am asked, "What is the best way to structure my new business?"

There are three possible legal structures to any business: a sole proprietorship, a partnership or an incorporated company. There are pros and cons to each of these structures.

Sole Proprietorship

A sole proprietorship is a business that is owned and operated by one individual. Under the law, a proprietorship is not a legal entity, but it does require the necessary business permits and / or operating licenses.

A proprietorship is regarded as an extension of the individual who owns it. The owner possesses all of the assets of the business. He/she is also responsible for all of the debts and liabilities of the business.

Any loans to the proprietorship are treated as personal loans to the individual. For income tax purposes, the profit or loss of the sole proprietorship is combined with other earnings of the individual.

Partnership

A partnership is a relationship involving more than one person for the purposes of owning and operating a business. A partnership can be established without obtaining government approval. There is no restriction on the number of individuals that may be involved in a partnership.

A partnership is a legal entity recognized under the law and as such has its own rights and responsibilities. A partnership can sign contracts, borrow money and obtain trade credit. Each partner is responsible for the liabilities of the partnership. When partnerships do not meet their financial obligations, creditors will often first go after the wealthier partners.

Creditors may require a personal guarantee from each of the partners before granting credit.

A partnership does not have to file income tax returns or pay income tax. However the profit or loss from a partnership is combined with the personal income of the partners for income tax purposes.

It is wise to create a partnership agreement that documents the rights and obligations of each of the partners. This can eliminate future problems in the event that one of the partners decides to leave the business.

Incorporated Company

An incorporated company is a separate legal entity. A company can be incorporated under either provincial or federal law.

The corporation is responsible for its debts. Typically, the owners or shareholders of the incorporated company are protected from most of the liabilities of the business. However, when an incorporated company is small and first starting out, creditors and banks may require personal guarantees from the principal owners before extending credit.

The corporation must file income tax returns and pay taxes on its income from operations.

Annual tax returns must be submitted to both the Federal and Provincial governments.

The legal and government registration fees for incorporation usually run in the \$1,000 - \$1,200 range.

The legal protection afforded to the owners of an incorporated company can often outweigh the expense of incorporation.

Which structure is best for me and my business?

There is no right or wrong answer. The structure that best suits your needs will depend upon several factors.

- Is more than one person involved in the ownership of the business? If so, then consider a partnership or an incorporated company. If only one person is involved in the business, then consider either a proprietorship or an incorporated company.
- What is your level of risk? Are you comfortable with the possibility of creditors coming after your personal assets? If you want to insulate yourself (and your partners) in the event of bankruptcy, it might be best to consider creating an incorporated company.
- Do you want to combine proprietorship or partnership income with other forms of personal income for income tax purposes? If you have little or no other source(s) of income, then combining proprietorship or partnership income can be considered. If you operate an incorporated company, you will have to pay personal income tax on the salary paid to you by the business.

- Can you afford the incorporation fees? As stated, incorporation costs will be in the \$1,000 - \$1,200 range. Some business owners with limited start up capital see this as an expense that they would like to avoid or at least defer until a future point in time.
- Do you want to have to file annual corporate tax returns with both the Federal and Provincial governments (as with an incorporated company)? There is a cost to do this. You will require an accountant to prepare and submit your returns.

Before starting your business, you would be wise to consult with both an accountant and a lawyer to ensure that you fully understand each of these options and their implications, in order that you can establish the structure that is best suited for both you and your business.

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