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The Benefits of Incorporating: What You Need to Know

This article discusses the benefits of incorporating compared to the other structures you can use in Ontario to carry on business. If you are just starting out on your "entrepreneur journey", the first decision you will have to make is what business structure to use. You have the choice to keep it "simple and inexpensive" by using a sole proprietorship structure, or you can jump right in and incorporate. This article discusses some of the issues to consider when making this decision.

What is Discussed in this Article

The Options Available to Carry on Business in Ontario
The Pros and Cons of Using a Sole Proprietorship or Simple Partnership
The Advantages of Incorporating
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The Options Available to Carry on Business in Ontario

There are three primary structures available to be used to carry on business in Ontario, which are as follows:

1. A sole proprietorship;
2. A partnership; and
3. A corporation.

There are some hybrid structures such as limited partnerships and joint ventures that may be appropriate for more complicated business ventures, but in general terms, the three structures listed above are the primary options.

The Pros and Cons of Using a Sole Proprietorship or Simple Partnership

The sole proprietorship is the simplest and most cost-effective structure to carry on business in Ontario if there will be only one owner. If you have more than one person involved in your business, the next simplest is the partnership structure, although a partnership has its own special statute to govern how it is operated called the Partnership Act.

Both of these business structures can be registered online in Ontario. You don't have to worry about things like who will be on the board of directors, who will be the shareholders, and what will be the rights and privileges attaching to each class of shares which are matters you do have to consider if you are going to incorporate.

The most difficult and important part of this process is coming up with an original name. This is required in whatever structure you decide to use. Ontario provides you cannot register the exact name that someone else has registered, but it is also not a good idea to use a name that is similar to another business. Even if this business has not filed a trademark application for the name, if the business name has been used actively in a specific geographic area the name will have common law protection. The extent of this protection is not a black-and-white issue, but the bottom line is using a similar name will expose you to litigation over the right to continue to use this name. If the owner of the name has filed a trademark application, the protection they will have to prevent others from using a similar name will be even broader.

The process of coming up with an original name has been made easier in the last few years by the use of AI software. You can type into the software a question such as "Does anyone in the southern Ontario area use the following name to carry on business?" The software will scour the internet and other public databases, and answer this question for you. It can also make suggestions as to what other names might be better. One such on-line service that allows you to open a free account is www.openai.com.

Another reason why you might want to at least commence business with either a sole proprietorship or partnership other than simplicity and cost is if you anticipate incurring losses in the early days of the business, and you have other sources of income upon which you pay income taxes. The losses earned by your unincorporated business may be able to be deductible to shield these other sources of income from tax. There are other exceptions to this rule, most notably the ability of the Canada Revenue Agency to take the position that the business you have started has no reasonable chance of ever earning any profit, but the general rule is that the losses generated by an unincorporated business will be deductible against your other sources of income.

The two most significant disadvantages of using either a sole proprietorship or a partnership structure to carry on business are the fact that neither structure provides limited liability to the owners, and neither structure offers the ability to take advantage of the Canadian "small business deduction". Both of these issues are discussed below as being two of the most important benefits of incorporating.

The Advantages of Incorporating

As you might have guessed, perhaps the most important benefit of using a corporate structure is that it provides limited liability to the owners who are the shareholders of the corporation. This is accomplished by the law establishing that a corporation is a separate legal entity from the shareholders. As a separate legal entity, it can contract in its own name and unless a guarantee in writing is provided by the shareholders for liability flowing from such a contract, the corporation alone is entitled to the benefits of the contract and is responsible for any liabilities associated with the contract. The statute that governs corporations in Ontario is the Business Corporations Act.

This limited liability is not absolute as corporate actors can be found personally liable for actions that are deemed by a court to be actionable wrongs, and several statutes relevant to the operation of a business in Ontario impose personal liability on directors of a corporation for unpaid amounts owed to the government. However, a general tenet of corporate law is that the shareholders of a corporation are not responsible for the debts of the corporation. Holding companies are set up as the sole shareholder of one or more operating companies. The operating companies carry on the business while transferring all profits to the holding company by declaring regular dividends.

Another mechanism that can be employed to shield the retained earnings of a corporation (profit retained at the corporate level and not distributed to shareholders) is to set up a “holding company” structure. One hundred percent of the shares of an operating company are issued to a 2nd corporation that is not exposed to the liabilities of the operating corporation. Net profit can then pass by inter-corporate dividends to the holding company. Once the funds are in the holding company, it can deal with these funds with an extra layer of protection from creditors. As can be appreciated, the CRA has a multitude of rules that can be relevant to this structure including what are called the “associated company rules” that limit the availability of the small business deduction among associated corporations which would catch a holding company structure. However, the theory of this structure is sound in protecting retained earnings from operating liabilities.

This is a good segue to the second most important benefit of the corporate structure in Canada which is the availability of the “small business deduction” to limit the applicable tax rate on “active business income” earned by a Canadian corporation to approximately 12.5%. This can be contrasted with the rate of approximately 45% for income earned by a corporation that does not qualify for the small business deduction.

The ability to earn active business income and pay tax on it at such a low tax rate, and then flow after-tax income up to a holding company to shield these funds from liability, is another reason why the holding company structure is so popular. However, as with all tax plans that attempt to limit the CRA’s cut, there are multiple exceptions and conditions to making use of this structure which are beyond the scope of this article.

What is a Board of Directors?

Both the federal corporate statute which is called The Canada Business Corporations Act and governs federally incorporate companies, and Ontario corporate statute which is called the Ontario Business Corporations Act, and governs provincially incorporated corporations, provide that the authority to manage the business and affairs of a corporation rests with the board of directors which in turn are elected by the shareholders. Every corporation must have at least one director, and if it has only one director that person must be a resident of Canada.

Both statutes impose the following duties on the board of directors, namely,

- the duty to act honestly and in good faith in dealing with the business and affairs of the corporation with a view to the best interests of the corporation; and
- the duty to exercise the care, diligence, and skill that a reasonably prudent person would exercise in comparable circumstances.

The failure of the board of directors to honor these duties can create a cause of action against them by the shareholders. However, that discussion is also beyond the scope of this paper.

It is possible under both statutes to delegate the powers of the board of directors to the shareholders using an agreement which is called a “Unanimous Shareholder Agreement”. This might be attractive where the corporation is controlled by a small number of individuals who want to have day-to-day carriage of the business of the corporation but also want to take advantage of the small business deduction that is available only to a corporation. The theory is that this document creates an “incorporated partnership”. The problem with this structure is that it may prejudice the limited liability of the shareholders. This structure should only be employed with the assistance of a competent corporate lawyer.

Key Takeaway

The decision as to whether to incorporate is based on your circumstances. For many start-up businesses, the costs involved may not be warranted. However at some point as your business grows, incorporating should be considered as the benefits discussed above will likely out-weight the disadvantages quite quickly.

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