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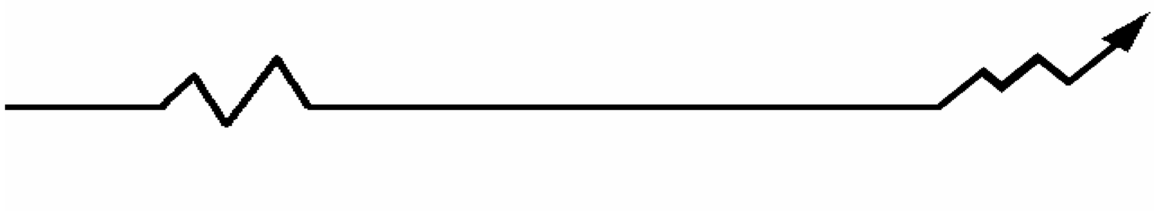

DISCUSSION PAPER #2

WHEN TO INCORPORATE

Should I Incorporate?

Many small business owners wrestle with this question unsure how to proceed. While every situation is different, generally, when the business owner has personal assets that they wish to protect, they should look into incorporating their business to provide them additional legal protections.

Issues to Consider

Legal

One of the key benefits of incorporation is protection of the business owners' personal assets. Under the law, corporations are treated as 'persons', distinct from their shareholders. As 'persons', corporations can acquire assets, enter into contracts, and access capital markets for financing. Furthermore, once a business name has been registered, that name is protected, and others are prevented from its use.

In the situation where a sole proprietorship went into bankruptcy, the owner would be held liable for all the business's debts. The owner could lose their house, car, savings, and even forced to declare personal bankruptcy if they were unable to cover the business's debts.

The legal liabilities of shareholders to general creditors are less than those of sole proprietors and partners. If the corporation were faced with legal or financial difficulties, the shareholders are only liable for the amount they have invested within the corporation. This issue is a key consideration when a parent wishes to protect assets to ensure the security of their estate.

Shareholders who are also directors may be personally liable for statutory liabilities such as Goods and Services Tax and Payroll Remittances.

With the additional legal protections provided, many business owners incorporate to ensure future security for both their families and businesses. Since a corporation can own assets, incorporating can also aid in protecting estates by defining liability for claims and ownership of assets. Simply put, the corporation's assets are the corporation's assets, while the owners' assets are the owners' assets. What happens to one does not necessarily affect the other.

Tax implications

Corporations are taxed on income at different rates than sole proprietorships or partnerships. Corporations are taxed at a rate of approximately 21% on the first $200,000 of taxable income, whereas a sole proprietorship is taxed at an average rate of 40% on the similar amount. And, as the income increases, so does the after-tax difference.

Unlike proprietorships and partnerships which are *unincorporated businesses* and must have a year end of December 31, a corporation may elect any date as its year end. This important since it may be advantageous to relate the year end to a natural business cycle or to defer payment of income tax.

The other main concern business owners have is the question, “At the end of the day, how much do I get?” Not only can incorporating save the business money on the way in, but it can also save its shareholders money on the way out - unlike other types of businesses, a corporation can issue dividends to its shareholders.

There are restrictions on issuing dividends, however, dividends may be taxed at a different rate than regular salary. When a person receives dividends, these dividends are taxed at an average rate of about 32%, while a regular salary may be taxed at an average rate of 40%.

Overall, these tax and legal distinctions seem quite attractive. As a business owner, there are additional issues that must be considered to determine whether incorporating a business is advisable.

Is the grass greener?

Although there are many benefits to incorporating a business, there are trade-offs. There are higher start-up costs and additional restrictions. The additional filings translate to more time spent on paperwork. In addition to the owner(s) filing of personal tax return(s), accountants are usually involved in preparing the corporate income tax return each year.

The corporation must also prepare financial statements. The financial statements must be prepared according to Canadian Generally Accepted Accounting Principles (and public companies must have their financial statements audited).

Process

Typically, business owners incorporate in the province in which they do the majority of their business. However, if the corporation does a significant amount of business in more than one province, it is a good idea to incorporate federally, as this provides additional legal rights.

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In incorporating a business, articles of incorporation must be drawn up. In the articles of incorporation, the business must,

- choose a business name that has not already been registered;
- identify a head office for business;
- issue shares, defining classes of shares, dividend periods, as well as terms for ownership and transfer of shares;
- elect directors; and
- define other corporate by-laws and restrictions (if necessary).

Once the articles of incorporation and necessary filings have been made, it usually takes about five to ten business days to receive incorporation papers

In conclusion, incorporating a business will benefit you through a combination of legal protections and tax advantages. As a business owner, you must ask yourself if you feel comfortable with the additional paperwork required once you incorporate your business.

For further information on incorporating a business, contact the professionals at SPA Group.

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