Whether to incorporate or not ? Some considerations for sole proprietors contemplating this move - by J. Lawson CPA, CGA

The following comments will be elementary to experienced corporate directors, however they may provide impetus for thought to sole proprietors considering the move to incorporation.

A full discussion of incorporation would require more space than is possible in a very short paper. As businesses grow, many will become incorporated, as the advantages eventually outweigh the disadvantages. The decision whether or not to incorporate should be based on consideration of a number of factors, including the type of business involved, its size (as measured by revenues, assets, profitability), the number and type of its customers, the number of employees, in addition to other factors.

Limited liability

Limited liability is perhaps the most frequently cited advantage of incorporation, however this advantage should be considered together with other advantages and balanced with all of the related disadvantages and responsibilities. Certain types of businesses may be more inclined to become involved in disputed claims or litigation with their customers, or with third parties, than others. When a business becomes a defendant in litigation, it will need to have the resources to defend itself, whether it is incorporated or unincorporated.

The impetus to incorporate

There are examples of businesses that were encouraged to incorporate simply because the advisor doing the incorporation stood to earn a fee from performing this service, while the inexperienced ongoing directors and shareholders may have had little idea what they were getting into. Beware of advisors singing the praises of incorporating who also stand to earn a fee in the process. The individuals who are going to be standing behind the company (the ongoing directors and shareholders) should first inform themselves by studying the relevant legislation. In

Canada, this will generally either be the Canada Business Corporation Act (“CBCA”), or one of Provincial business corporations statutes, such as the Ontario Business Corporations Act (“OBCA”). For the uninitiated, under the legislation, the corporation is supposed to keep "books and records", which implies A) a minute book, which should be kept up to date with pertinent resolutions and B) a reasonable chart of accounts, where financial transactions are recorded and kept up to date. The corporation has an obligation to present a properly prepared set of financial statements, for which the directors take responsibility, to its shareholders for approval at the annual meeting. The corporation also has to file a corporate tax return, within the prescribed time frame. An inexperienced small corporation that does not keep a proper set of up-to-date accounting records will frequently be presenting its accountant with a "shoe box job" at year end, asking him or her to transform a pile of receipts into a proper set of financial statements. This work may involve an entirely separate reconstructive bookkeeping engagement that will be time consuming and costly for the company, before financial statements can be finalized.

Both the CBCA and OBCA provide for the appointment of an auditor, however in the case of a corporation that is not offering its shares widely, the auditor may be dispensed with by the directors and shareholders. This will generally be the case for a small corporation that does not otherwise require an audit and for which the payment of substantial audit fees to a public accountant, specifically licensed for that purpose, would not be cost effective.

Fiduciary duty

The directors are considered to be “fiduciaries” of the corporation on whose board they sit. They have a duty to avoid conflicts of interest, to place the interest of the corporation before their personal interests, to maintain confidentiality of the corporation’s information and to act in an objective, independent manner. These responsibilities become particularly relevant when the corporation has shareholders, such as minority shareholders, who are not involved in the day to day management of the corporation’s affairs.

Remuneration of officers and other employees

Corporate officers should be aware that because of the nature of their relationship with the company and their responsibility to it (they are not merely "consultants") they will almost certainly be expected to remunerate themselves via payroll payments which will be subject to source deductions payable to the Canada Revenue Agency ("CRA"). The same applies to other employees of the corporation. The directors and officers should also have a good grasp of the criteria for determining, of the people who perform work for the company, who is self employed and who is an employee and to remit source deductions for the employees.

The directors of a corporation should keep in mind that they may still be personally liable in the event of non-payment of employee source deductions, workers' accident insurance premiums and HST.

Bankruptcy and insolvency

When a company is insolvent or in financial distress, the directors owe a duty of care not just to the corporation and its shareholders, but to a variety of additional stakeholders, including the company's creditors. For example, a bankruptcy proceeding does not absolve the directors of responsibility for remitting the HST. The Canada Revenue Agency (CRA) may issue a director's assessment to a director who chooses, for example, to use amounts earmarked on account of employee source deductions or goods and services tax ("GST") in a failed attempt to continue to run a business.

Income tax advantages

The tax advantages of incorporation may include the small business deduction (for eligible Canadian Controlled Private Corporations) with its resulting lower corporate tax rates. Corporate directors who are shareholders have the flexibility in taking their compensation in the form of dividends or salary. The use of a corporation can permit the director-shareholders some flexibility to minimize their overall taxability, over time, by managing their liability for income tax across different years. They will no longer be able to offset the business' loses directly against their other personal sources of income, as they could when they were unincorporated.

<u>Corporate finance</u>

Use of a corporation provides the principals with the ability to loan money to the corporation and to have it repaid, subject to the stipulations of the Income Tax Act, which include income attribution rules. Corporations also have advantages unavailable to sole proprietors, by being able to obtain financing from 3rd parties by way of share issues. The directors of a corporation contemplating a share issue (or an issue of other types of corporate securities) need to be mindful of the applicable securities laws, which are complicated. In Canada, there are national policies for the issuance of securities, however the most of the pertinent legislation is at the Provincial level. Contravention of securities laws can have significant consequences.

The foregoing advantages and disadvantages must be considered in relation to the responsibility involved in establishing and maintaining a corporation. Unless the principals are truly prepared for what they are getting into, it may not make sense to incorporate and they may be better advised to continue as sole proprietors or in a partnership for a period of time. Incorporation should only be done after the principals have truly informed themselves and are prepared for the responsibility they are about to take on.

The forgoing is intended for discussion only and it not purported to be and should not be construed as legal advice. For legal advice, readers should consult qualified legal counsel.

In order to be properly informed about all the implications of incorporation, it would be a good idea to meet with a qualified advisor, such as an experienced Chartered Professional Accountant, for a detailed consultation.