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SMALL BUSINESS ADVICE

INFORMATION FOR CLIENTS

Often clients in business or wishing to start a new business are faced with a number of choices. Below, we discuss some of the common questions which arise from time to time. The information provided is for general guidance only. Please consult with us and with your accountants to ensure that your specific situation does not require special advice or measures.

BUSINESS ORGANIZATIONS

Sole Proprietorship and Partnership

A single person, often referred to as a *sole proprietor*, may carry on a business in his or her own name or under another name called a *business name*. Two or more persons, in association or partnership, may carry on a business in their own names or under a business name. A business name is simply a method of identifying a particular business. It may be a combination of the partners' names or a coined word and is used because the proprietors of the business feel that it is more attractive to the public than the use of their own names. In Ontario, a business name must be registered with the Ministry of Government Services, Companies and Personal Property Security Branch (CPPSB). The current fee is \$60.00 and is valid for five years. Registration may be completed on-line. Further information and links to on-line forms and registration is available at the Service Ontario website ("Business" section)

The business is still that of the individual proprietor or partners. They are personally responsible for payment of all debts and taxes of the business and, if something goes wrong, they must pay any liability claims against the business. In a partnership, each partner is liable for the full partnership debt.

Advantages of sole proprietorship and partnership include low startup costs, minimal government regulation and some initial tax advantage in being able to deduct business losses against other income. Disadvantages include unlimited personal liability for all business debts and liabilities, and no business succession on death. In the case of a partnership, one partner has ability to commit all partners for debts and liability unless potential creditors or others are advised **in advance** of any limits to commit. It may be difficult to arrange financing or raise capital but easier, with more partners, to commit to and pay debt. There is no succession on death and absent an agreement, a partnership is dissolved on death of any one partner.

Corporation

A *corporation* on the other hand, is a distinct legal entity, separate from the individuals who own or operate the business. In most cases a corporation does not have any restrictions on its powers and may conduct all business affairs. Usually, it has the same rights, powers and privileges of a natural person. Therefore, think of it as a separate person for legal and tax purposes.

All liabilities incurred by the corporation are limited to its assets and are not the liabilities of the owners or directors of the corporation. This, of course, is quite apart from any liabilities which either the owners, directors or officers may guarantee personally, such as loans from banks or suppliers. In addition, by law, certain liabilities are imposed on officers, directors and others and are more particularly discussed below.

In order to retain limited liability, it is necessary that all of a Corporation's business be carried on in its corporate name. Persons executing documents on behalf of a Corporation must ensure that they do so as representatives of the Corporation and not personally. This is done by persons signing such documents using the name of the Corporation and either the word "per" or the name of their office or signing capacity ("president", "secretary" "authorized signing officer" next to, or immediately below, their signatures.

A Corporation must identify itself to the public and those with whom it carries on business by its proper corporate name. This name must appear on all advertising and promotion documents, contracts, invoices, cheques and other corporate documents.

A corporation is *incorporated* by filing a document known as *Articles of Incorporation* and a data base name search known as a *NUANS name search report*, with the CPPSB. The Articles of Incorporation contain details of the proposed name of the corporation, its official address, the name and address for service of the first director and details of the share structure of the corporation. It is important that the Articles be properly drafted and professional advice should be sought and obtained before filing. The current government fee for incorporation is \$360.00. A name search costs approximately \$55.00. There will be further expenses for a minute book, share certificates and a corporate seal. Corporations may also be incorporated under a number name only (eg. 123456789 Ontario Inc.) in which case no NUANS name search report is required. Incorporation may be effected on-line.

Advantages of incorporation are that the owners are not liable for debts of the business unless they guarantee them or, as noted, are obliged to pay by statute, and ownership is transferrable. The Corporation does not dissolve on death of an owner. Furthermore, there are tax advantages in being able to spread profits and freeze growth in the hands of various investors or owners and tax free capital gains on sale of shares in certain instances. Also, it may be easier to raise capital by giving ownership interest or share of profits to investors.

Disadvantages of incorporation are that it is more expensive at start-up and following there are higher ongoing expenses in keeping additional set of books and filing additional tax

returns and more government regulation to follow and more forms to file. There is potential double taxation between corporation and its owners when higher levels of profit are achieved. As well, initial losses cannot be passed on to owners, but can be used against future profit.

INCORPORATION

Business Names

Whether one intends to register a business name or to incorporate, a name must be chosen which does not conflict with the name of an existing entity. The test usually is whether or not the proposed name would cause confusion, in the minds of the persons who might be expected to patronize the business, between the new business and an existing entity. As well the proposed name cannot cause someone to think that the proposed business is somehow a part of or associated with an existing entity, whether or not that entity is a business, government agency, non-profit entity or otherwise. For example, one could not open a store for the sale of general merchandise under the name of “Walter-Mart” or “Seers” because these could easily be confused with existing, known businesses.

Also, a corporate name cannot be too general; or only descriptive, in any language, of the quality, function or other characteristics of the goods or services in which the corporation deals or intends to deal; or primarily or only the name or surname of an individual (other than the principal of the business) who is living or has died within thirty years preceding the date of filing the articles; or, primarily or only a geographic name used alone, unless the proposed corporate name has been in continuous use for at least twenty years prior to the date of filing the articles or the proposed corporate name has through use acquired a meaning which renders the name distinctive.

Furthermore, no word or expression in any language, that is obscene or connotes a business that is scandalous, obscene or immoral or that is otherwise objectionable on public grounds, may be used in a corporate name. No word, expression or abbreviation, the use of which is prohibited or restricted under any law unless the restriction is satisfied, may be used in a corporate name. Words which imply the corporation has some status which is not so or carries on a professional practice when it is not licensed to do so are also prohibited. Examples include the words: *amalgamated, architect, association, club, college, institute, university, condominium, co-operative, council, engineer, housing, and veteran.*

No word or expression that misdescribes, in any language, the business, goods or services in association with which the corporate name is proposed to be used; the conditions under which goods or services will be produced or supplied or the persons to be employed in the production or supply of these goods or services; or the place of origin of the goods or services produced or supplied by the corporation, may be used in a corporate name.

If desired, the Corporation may carry on business as or identify itself under a different name but only if a registration is effected under the *Business Names Act* (Ontario) in the same manner as a sole proprietorship or partnership must register. Even if a business style name is

registered, the proper name of the Corporation must be shown as above noted, although it need not be as prominently displayed as the business name.

Corporate Structure

A corporation is owned by its *shareholders*. The degree of ownership is determined by the number of shares issued to each person. If more shares are issued by the corporation the percentage of the corporation which each person owns is diminished. For example, if you own one of the fifty shares issued, you own 2% of the corporation. If fifty more shares are issued and you do not subscribe for any of them, you only own 1% of the corporation. It is possible to issue different types of shares so that some shareholders do not have a right to vote at meetings of shareholders or that profits are divided differently between different classes of shareholders. Also, some shareholders can have the equity or growth of the corporation while others may not share in same but only have rights to get their initial payment for the shares back plus, perhaps, unpaid dividends. Effectively, the management, share of profits and share of growth can be split between different groups of shareholders and some groups can be excluded completely.

A corporation is run by its *Directors*. The Articles of Incorporation may provide for a flexible number of directors as the shareholders and directors determine from time to time. Directors must manage and supervise the business affairs of the Corporation. Directors may be paid for their services as reasonably determined by them.

Each director must be at least eighteen years of age, mentally competent and may not be a bankrupt. A majority of directors must be Canadian citizens, or persons who are landed immigrants who have not been ordinarily resident in Canada for more than one year after first being eligible to apply for Canadian citizenship.

A Corporation must appoint *officers* including a President and Secretary and may appoint such other officers as it sees fit. Officers need not be directors. They are supervised by the directors and carry out such duties as determined by the Directors and the by-laws of the Corporation.

Directors' Liability

Although corporations are distinct legal entities and liability for debts is limited to corporate assets, directors may be **personally** liable in certain instances. Various laws impose liability on directors. By way of example, directors are liable for the corporation's failure to remit employee tax, CPP or EI deductions, for up to six months' unpaid wages and twelve months' vacation pay and for unremitted HST. Also directors may be liable for environmental damage caused by the corporation because of their failure to take reasonable care to prevent the corporation from causing an unlawful discharge of pollutants. Directors may also be liable for failure to take reasonable care to ensure safety in the workplace. Many statutes require **active** management of the corporation. It is not enough for a director to say that he or she did not know. In addition, common law duties imposed on directors are increasing and liability may be

imposed for failure to take reasonable steps to ensure the business of a corporation is properly managed and shareholders or others suffer a loss as a result.

TAXATION

Matters of taxation are very complicated and the input of professional advisors is strongly recommended. Generally, for sole proprietorships, all income and expenses are for the account of the owner of the business. The sole proprietor will include the business income and expenses as part of his or her personal income tax return, usually filed in April in every year. There is very limited room for tax planning.

For a partnership, the individual partners must report the partnership income in every year as part of their personal income tax returns. Usually the partnership will provide a statement and the partners must **report** the whole of the income and expenses of the partnership and **declare** the individual partner's share of income as part of that person's income for taxation purposes. Please note that all partners must declare their income and expenses in the same taxation year.

A corporation is considered an individual for tax purposes. It files separate tax returns, one for federal Corporations Tax and one for provincial Corporations Tax. Rates of tax are different for corporations and there is a special, lower rate for active small businesses. Since individuals are taxed when they take money out of the corporation, the intention, for small businesses, is that the combined tax on the business income and dividends paid to shareholders should be equal to the tax an individual would pay on his or her own income. Losses cannot be transferred to the individual owners.

Whether or not the business is a sole proprietorship, partnership or corporation, it must register for HST and obtain a business number which it will use for remitting the HST and all other required remittances such as employee tax deductions, Employment Insurance contributions and Canada Pension Plan contributions, including the amounts required to be deducted from employees and the employer's required contribution. Furthermore, where employees are hired, depending on the amount of the total payroll, the business may be required to pay provincial Employer Health Tax. Depending on the nature of the business activities, registration with the Workers Safety Insurance Board and payment of premiums may also be required.

Either a proprietorship, partnership or corporation may hire family members of the owners. These people can be paid a reasonable salary for the services they actually perform. Such salary must be similar to what would be paid to a stranger hired to perform the same services.

Corporations provide special opportunities for tax planning. Money paid out of a corporation can be taken in the form of dividends or salary. Up to certain limited amounts, because of special tax treatment accorded to dividends, the dividends may be paid out tax free. Bear in mind however, that the corporation itself will have paid tax on its profit. More

important, corporations provide the opportunity to give family members a share of the growth of the business. By enabling family members or trusts set up for family members to acquire shares in the business at its inception, when the shares have little value, the increase in value is shared by all members of the family. Perhaps most important, the first \$750,000.00 of gain (profit) on the sale of shares of an active Canadian business corporation is currently tax free to each shareholder.

PARTNERSHIP AND SHAREHOLDER AGREEMENTS

There are certain rules contained in various laws which govern how a partnership or corporation which has more than one shareholder (owner) may be governed. Some of these rules may prove impractical to the operators of the business and some of them may lead to unwanted results. For example, in a partnership, on the death of a partner or if any partner decides to end the partnership the partnership must be dissolved. This means that all the business assets must be sold, its debts paid and anything left over distributed to the partners. This would have the effect of destroying the business and its goodwill. Likewise, if shareholders of a corporation cannot get along, one shareholder may apply to the courts to liquidate the business or for a mandatory buyout.

Therefore, it is necessary to have an agreement to provide some rules between the partners or shareholders which will provide for the eventualities and give the parties the opportunity to decide between themselves what is fair, while they all have good intentions. It is usually too late to try to resolve these matters on a friendly and fair basis when one of the parties feels that he or she has been wronged in some way.

Matters to consider include the following:

- Are equal numbers of shares being issued to each shareholder?
or Will one shareholder be getting more shares?
- Will any shareholder/partner have greater rights in terms of votes or decision making?
- Will any shareholder/partner have greater rights in terms of distribution of profit?
- Will any shareholder/partner have greater rights in terms of equity in the assets of the corporation/partnership?
- Can shares in the company or interests in the partnership be transferred without consent of the other shareholders/partners?
- Who can sign cheques or contracts? Is there some limit which requires the signature or consent of more than one or even all of the partners or shareholders.

- Is any shareholder/partner (or a related person or company) the owner or landlord of the premises at which the business is carried on?
If so, what protection does the company have for the location?
- What jobs do each of the shareholders/partners have in the business?
- Does one shareholder/partner devote more time than the others?
Does that person get any more money for doing so?
- How is the business being initially financed?
Does one shareholder/partner put in more money than the others?
Is that person secured for such funds?
Does that person receive any money for providing such financing?
- What discretion does a single shareholder/partner have in committing the business to any contract, expense, job, customer credit or otherwise?
- What things must be decided unanimously?
- How is income from the business split?
Do all shareholders/partners get the same payments at the same time?
- What if a shareholder/partner gets sick?
Does he/she keep getting his/her full draw forever or for a limited time?
If a replacement person is hired, does this come off his/her draw or is it charged as a business expense?
Can the other shareholders/partners buy out his/her interest if he/she is disabled for more than six months?, one year?, any time?
Can he/she or his/her family force the others to buy out his/her interest if he/she is disabled for more than a specified period of time?
- If the answer to either of the above is yes, how is the buyout price determined?
Book value of assets?
Market value of assets? As determined by who? What about unrecorded assets such as goodwill?
Multiple of last year's or last three years net earnings?
Multiple of persons last year's or last three years salary/dividends?
Plus the person's share of retained earnings?
Is the company buying disability insurance on any shareholder/partner to maintain operations in view of the loss of the contribution of a disabled shareholder?

- What if a shareholder/partner dies?

Do heirs/family keep shares/partnership interest forever and get salary/dividends/equity?

Do heirs/family have the right to force the remaining shareholders/partners to purchase the shares or to dissolve the partnership?

Do the remaining shareholders have the right to force the survivors to sell them?

If the answer to any of the above is yes, how is the buyout price determined? (See above)

Is the company buying life insurance on any shareholder/partner to fund any buyout or to maintain operations in view of the loss of a managing shareholder?

- What if a shareholder wants to leave or have the business sold?

Does one party have the right to require the other(s) to purchase his/her shares/partnership interest ? (“put option”)

Does one party have the right to force the other(s) to sell to him/her ? (“call option”)

Does he/she have the right to sell shares/partnership interest to an outside party ?

If so, can he/she require the other shareholders/partners to sell their interests as well ? (“take along”)

If so, can the other shareholders/partners require that the purchaser purchase their interests as well (“piggy back”)

- If one party has the right to buy or to sell shares or a partnership interest, how will the price be determined?

Book value of assets?

Market value of assets? As determined by who?

What about unrecorded assets such as goodwill?

Multiple of last year's or last three years net earnings?

Multiple of persons last year's or last three years salary/dividends?

Plus the person's share of retained earnings?

Any discount from the above numbers if the leaving party forces a purchase? or if the remaining parties force a sale?

How will the money be paid?

All cash on closing?

Part cash (a % of the price or fixed amount) and part credit?

Term?

Amount of each payment?

Rate of interest?

- Do the parties wish to hold an auction with the shares going to the highest bidder ?
Who will conduct? Any minimum price ? Any restrictions on who can bid/buy ?

- Does a shareholder have the right to sell shares or a partner have the right to transfer a partnership interest to any outside party subject to the other shareholders/partners having the right to purchase on the same price and terms? (“first right of refusal”)?
- Does a shareholder have the right to force a sale by offering to sell his/her shares/partnership interest to the others or requiring them to sell their shares/interest to him/her, as they choose, at a price named in an offer (“shotgun buy/sell”)?
- Does a shareholder/partner have the right to require that the whole business be sold? If so, can the others insist on a certain minimum price?
- Can a shareholder/partner be forced to leave?
If so, under what circumstances? Who decides?
If so, at what price are his/her shares or partnership interest purchased?
- If a person leaves is there any restriction on him or her competing with the business?
Restricted from dealing with certain customers/suppliers?
Geographic area?
Time?

The foregoing is a brief outline only of some of the issues involved in starting a new business or continuing the operation of an existing business. Specific types of business have various licensing and other requirements. Individuals may also have specific requirements in terms of tax, estate and family law planning. Please consult with us and with your accountants as is necessary. This information is updated as of December, 2013.