

New Business Toolkit Series

CHAPTER ONE:

Selecting a Legal Entity

This handy reference guide to help you navigate the financial, tax and accounting considerations when starting a new business.

We hope you enjoy this e-publication.

We understand what it's like to be a business owner. We know you spend your days, and sometimes evenings, being pulled in several directions at once. You work hard to juggle all of the tasks needed to keep your business running, not to mention, serving your customers and providing the great products or services that were the reason they chose you in the first place.

Work smart, not hard and let Ashcroft & Associates lighten your to-do list.

Tell Us About
Your Business

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Ashcroft & Associates is dedicated to serving the Comox Valley's business and personal tax clients. Our experienced accounting staff offer accounting, bookkeeping, tax compliance and other business services to help your business move forward.

Selecting the Legal Entity for Your Business

One of the first major decisions you will have to make as you start your new business is the form of legal entity it will take. To a large degree this decision may be dictated by the way you have organized your operations and whether you intend to work on your own or in conjunction with others.

The form of entity you choose can have a significant impact on the way you are protected under the law and the way you are affected by income tax rules and regulations. There are three basic forms of business organizations. Each has its own benefits and drawbacks and is treated differently for legal and tax purposes.

Sole Proprietorship

A sole proprietorship is typically a business owned and operated by one individual, or very often by a husband and wife. A sole proprietorship is not considered to be a legal entity under the law, but rather is an extension of the individual who owns it. The owner has possession of the business assets and is directly responsible for the debts and other liabilities incurred by the business. The income or loss of a sole proprietorship is combined with the other earnings of an individual for income tax purposes.

A sole proprietorship is perhaps the easiest form of business to own and operate because it does not require any specific legal organization, except of course, the normal requirements such as licenses or permits. A sole proprietorship typically does not have any rules or operating regulations under which it must function. The business decisions are solely the result of the owner's discretion.

Partnerships

Partnerships can take two legal forms, general or limited. In a general partnership, two or more individuals join together to run the business enterprise. A partnership must usually file an operating business name statement to operate a business under the partnership name. Each of the individual partners has ownership of company assets and responsibility for liabilities, as well as, authority in running the business. The authority of the partners, and the way

in which profits or losses are to be shared, can be modified by the partnership agreement. The responsibility for liabilities can also be modified by agreement among the partners, but partnership creditors typically have recourse to the personal assets of each of the partners for settlement of partnership debts.

A limited partnership is comprised of one or more general partners who are personally liable for partnership debts, and one or more limited partners who contribute capital and share in the profits or losses of the business. The limited partners do not take a part in running the business and are not liable for the debts of the partnership.

The rights, responsibilities and obligations of both the limited and general partners are typically detailed in a partnership agreement. It is a good idea to have such an agreement for any partnership, whether limited or general.

A partnership is a legal entity recognized under the law and as such it has rights and responsibilities in and of itself. A partnership can sign contracts, obtain trade credit and borrow money. When a partnership is small most creditors require a personal guarantee of the general partners for credit.

The partnership is also required to prepare financial statements for both federal and provincial tax purposes. A partnership typically does not pay income tax; the information from the tax return is combined with the income of the partners to determine their overall tax liability.

Corporation

A corporation is a separate legal entity which exists under the authority granted by law. A corporation has substantially all of the legal rights of an individual and is responsible for its own debts. It must also file income tax returns and pay taxes on income it derives from its operations. Typically, the owners or shareholders of a corporation are protected from the liabilities of the business. However, when a corporation is small, creditors often require personal guarantees of the principal owners before extending credit. The legal protection afforded the owners of a corporation can far outweigh the additional expense of starting and administering a corporation.

A corporation must obtain permission from the Minister of Finance to use or do business under a corporate name. A corporation must also adopt and file articles of incorporation and by-laws which govern its rights and obligations to its shareholders, directors and officers.

Corporations must file annual income tax returns with the Canada Customs and Revenue Agency and possibly with the Province of British Columbia depending upon its circumstances. The elections made in a corporation's initial tax returns can have a significant impact on how the business is taxed in the future.

Incorporating a business allows a number of other advantages such as the ease of bringing in additional capital through the sale of equity, or allowing an individual to sell or transfer their interest in the business. It also provides for business continuity when the original owners choose to retire or sell their interest.

Should you decide to incorporate your business venture, you should seek the advice of competent legal counsel and business oriented accountants.