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Should you incorporate your small business?

When a business is started, it can be structured as a proprietorship, partnership, or corporation.

Following is an overview of each of the structures:

Proprietorship

A **sole proprietorship** is one person operating a business, without forming a corporation. The income of the business is then taxed in the hands of the owner (the proprietor), at personal income tax rates. The income is considered income from self-employment, **and is included on the personal income tax return of the owner**.

Advantages of proprietorship:

- Setting up a business in the form of a proprietorship is very simple and the costs are low
- If the business loses money, the losses can be utilized to lower your taxable income from other income sources.
- The cost of the tax return preparation are fairly low at a cost of $300 - $400.
- The net income that you make increases the room for RRSP contribution

Disadvantages of a proprietorship:

- The business is not a separate entity from the owner. The proprietor is liable for all liabilities of the business.
- By the same token, if the business is sued, all the personal assets of the owner are at risk.
- Any profit earned by the business is taxable in the hands of the owner at whatever the tax rates are for that level of income. Our tax rates increase as you make more money. So, if you are lucky enough to make over $200,000, it is taxed at 53% in Ontario.
- As a sole proprietorship, you will need to pay both the employer and employee portion of CPP which is $6,300 total in 2021, if you make $61,700
- A proprietorship has a lack of permanence - if the owner dies, the net business assets pass to the heirs, but valuable leases and contracts may not.

Partnership

A partnership is also an unincorporated business. It is similar to a proprietorship, except two or more entities are partners in the business. For partners who are individuals, the income from the partnership is taxed at personal income tax rates, and a percentage of the income is included on the personal income tax return of each owner.

Advantages of partnership:

- The setup costs of a partnership are relatively low.
- A partnership is less regulated than a corporation. A partnership agreement should be drawn up to outline the terms of the partnership, what happens in the event of dissolution, and what happens in the event of disagreements among partners. In the absence of an agreement, or if certain provisions are not addressed in the agreement, provincial or territorial laws will determine some or all of the terms of the partnership.
- Business losses can be written off against other income of the partners.
- Broader base of experience, knowledge and skills to draw from.
- The net income that you make increases the room for RRSP contribution

Disadvantages of a partnership:

- The biggest disadvantage of a partnership is unlimited liability. The partners are jointly liable for all debts and other liabilities of the business. If the business is sued, all the business and personal assets of the partners are at risk.
- Decisions must be made jointly.
- If the business is profitable, it will usually be paying higher taxes than if it was incorporated as a Canadian controlled private corporation (CCPC). See this same topic above under proprietorships.
- The death or retirement of a partner will not end the partner's liability for debts and obligations of the partnership that were incurred prior to the death or retirement. Also, if a partner retires and does not make the retirement publicly known, he/she could still be held liable for obligations incurred by the partnership after the retirement.

Corporation

A corporation is a separate legal entity, which is formed by application to either the federal government, or one of the provincial/territorial governments. The corporation issues shares to the owners, or shareholders. The funding of the corporation can be done through the issue of shares, or by borrowing. Instead of investing a large amount in shares, shareholders can lend money to the corporation, and invest only a minimal amount in the shares. This way, when the corporation has available cash, the shareholder loans can be repaid without attracting personal income tax.

Being a separate legal entity, a corporation pays corporate income tax, which is calculated completely separately from the owners' personal income tax. If the corporation pays wages to the shareholders, income tax and Canada Pension Plan contributions, and ***sometimes*** Employment Insurance premiums, must be deducted and remitted to Canada Revenue Agency.

Advantages of incorporation:

- One of the biggest advantages of incorporating a business is limited liability. This means that the liability of the shareholders is usually limited to the amount that they have invested in their shares in the corporation.
- However, many incorporated small businesses are not able to get bank loans without the personal guarantee of the shareholders, so this eliminates part of the advantage of limited liability.
- The personal assets of the shareholders are protected from lawsuits against the corporation. However, directors of the corporation can be held legally liable for some debts of the corporation (such as GST/HST and payroll taxes) in certain circumstances.
- Another major advantage for a profitable small business is the income tax advantage. A Canadian controlled private corporation, or CCPC, pays a much lower rate of federal tax (small business rate – 12.2% 2020) on the first $500,000 of active business income. Small business income generally does not include investment income or rental income, which is taxed at regular corporate tax rates. The combined federal + provincial small business tax rate of 12.2% in 2020 for the first $500,000, depending on the province, and from 31.5% for income over the threshold.

- Income can be left in the corporation if you do not need it personally. This means that you will be taxed personally ONLY on the income you take out of the corporation. Keep in mind that this tax advantage is only a deferral of taxes until the profits are paid out to the shareholder. If all the profits are paid out to the shareholder as they are earned, leaving the corporation with little or no taxable income, then they will be taxed entirely as income of the shareholder or employee, at personal income tax rates.
- One of the most common ways of taking money out of the corporation is through dividends. At $50,000, you pay virtually no tax personally; however, you will have paid corporate tax on the income already.
- If you pay yourself in dividends, you save yourself $6,300 in CPP contributions! (but the downside is you are not contributing towards your CPP).
- Another tax advantage of incorporation is the $850,000+ capital gains deduction on the sale of shares of a qualifying small business corporation. One of the qualifications is that the corporation must be a CCPC with active business income.
- Private Health Service Plans can be used to provide tax-free benefits to employees. This deduction is also available to sole proprietors and partners, but the treatment for corporations is more favorable than that for unincorporated businesses.

Disadvantages of incorporation:

- Incorporation takes a little more time and care to set up, but the benefits far exceed the minimal time and money investment.
- A corporate tax return costs in the $1,500 range to prepare.
- Business losses cannot be written off against other income of the owners (shareholders).
- Corporate tax returns are filed separately from the owners' personal tax returns.
- If you pay yourself in dividends, it does not generate any RRSP for the individual.

Generally, if your income is $50k or less or $200k or more, the financial benefits are more advantageous to incorporate instead of remaining as a proprietorship.

No matter what the type of business structure, spouses and children can be employed by the business, thus effectively splitting income. However, amounts expensed must be reasonable amounts based on services provided, and must actually be **paid** to the spouse and/or children.

Each type of business entity has its advantages and disadvantages. It is wise to seek professional advice to assist in your decision-making, and in the setting up of your business structure. It is also very important to get your accounting records set up and organized properly at the start of your business.