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Incorporation vs. Sole Proprietorship

"ThINC. about it"

by Michael R. Low

Proper business structuring is an essential ingredient in establishing a successful company. When structuring a business, many first-time entrepreneurs find themselves confused and frustrated. This understandable predicament is further complicated by the fact that most provinces have countless types of available business organizations. Like a wide-eyed kid in a candy store, the average businessperson gazes from afar, entirely unsure which seemingly delicious option is right for them. This article will briefly outline the advantages and disadvantages of two basic business organizations—the *incorporation* and the *sole proprietorship*.

A corporation is a legally created entity that is separate and distinct from the individuals who establish it. The corporation can act as a single person in forming contracts, conducting business, and even purchasing property. In Alberta, any one or more persons may form a corporation.

The benefits of incorporating a business are many, however this article will focus only on the main advantages. Firstly, a corporation protects individual shareholders from personal liability arising from operation of the business. Thus, where the corporation is liable, the shareholders are not. For example, if an incorporated business loses a lawsuit, the shareholders will not be forced to pay the judgment out of their own pockets.[1]

There are also various tax advantages stemming from incorporation. Corporations may be able to defer taxes using the Small Business Deduction. Additionally, there is the prospect of absolute tax savings through income splitting, deductibility of interest on borrowed funds, or converting capital losses to business investment losses.

Furthermore, corporations exist *in perpetuity,* meaning that the company still exists following the death of a shareholder. Corporations can easily accommodate large numbers of investors, each having different degrees of corporate control. Also, some government grants and bank loans are only available to corporations.

Nevertheless, incorporating a business is not free of disadvantages. Most notably are the large startup costs for corporate registration and legal fees. It is also more expensive to maintain a corporation because of the need to file regular corporate reports, as well as a separate tax return.

Many banks will not issue loans to newly incorporated businesses because of the typically limited asset-base for collateral. Also, before a loan is issued to a corporation, the directors are often required to give a personal guarantee, which negates the personal liability shield offered by this type of business structure.

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[1] "Piercing the corporate veil" is where the court will hold shareholders, officers, and/or directors personally liable for the actions of the corporation. This is an exception to the shield of liability typically enjoyed by the shareholders, officers, and/or directors of a corporation. Corporate directors are jointly and severally liable for some unpaid wages, unpaid GST or employee source deductions, some environmental issues, and for some corporate actions that are against the Business Corporations Act. For an exhaustive list, please speak with a corporate lawyer.

Finally, making changes to the corporation can be very difficult, expensive, and time consuming. Among other things, it involves making new corporate resolutions and filing documents with the corporate registry offices.

A sole proprietorship is a business where a single individual owns all the assets, owes all the liabilities, and operates the business in his or her personal capacity.[2]

Similar to corporations, there are numerous advantages and disadvantages involved with sole proprietorships. Dealing first with the benefits, establishing a sole proprietorship is much cheaper than incorporation. The only real cost associated with starting a sole proprietorship is registering a trade name, which is only necessary to avoid possible overlap in business titles.

In addition to being cheaper, sole proprietorships are also much simpler to operate. Because it is a single individual making all business decisions, there is no division of authority as in a corporation. Also, there is no need to file a separate tax return for a sole proprietorship. All business income is merely reported on the general tax return form.

As a sole proprietorship, the business owner is personally liable for all of the business activity. This makes it much easier to obtain bank loans because the bank can use the business owner's personal property as collateral. Moreover, making any changes to a sole proprietorship is relatively effortless because there is no need to complete any resolutions or documents.

On the other hand, the sole proprietorship also has its share of difficulties. The largest setback of the sole proprietorship is that it leaves the business owner open to unlimited personal liability for all business activity. This liability includes any tortious actions of the business employees. Hence, if an employee causes property damage while performing employment duties, it is the business owner who will be held entirely liable for the damages.

Lastly, the death of a sole proprietor results in the termination of the business. The assets and liabilities of the business then become part of the owner's estate because the existence of the proprietorship depends entirely upon the individual efforts of the owner. This may disadvantage the owner's beneficiaries because they would be left having to pay the outstanding business debts.

In conclusion, choosing a business type is a decision that must not be taken lightly. The advantages and disadvantages need to be considered before taking the next step of formal business organization. The key things to consider are: the uninsurable risk involved, the number of people, the borrowing requirements, the employee participation, the costs, and the income taxes. As each situation is different, receiving professional legal advice is optimal. Just remember to "Th*INC.* about it."

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[2] *Black's Law Dictionary; Eighth Edition*, Thompson West, 2004. Pg. 1427.