Types of Business Ownership

From a legal point of view, there are three common types of businesses: **sole proprietorship**, **partnership** and **corporation**. Each has different and important implications for liability, taxation and succession. A lawyer or accountant can advise you on which is suited to your needs, and undertake the necessary formalities. Using one of these legal forms of business, an entrepreneur can create a new venture, purchase and existing business, or buy into a **franchise**.

SOLE PROPRIETORSHIP

A sole proprietorship is the simplest way to set up a business. A single owner is fully responsible (liabilities) for all debts and obligations related to his or her business. A creditor with a claim against a sole proprietor would normally have a right against all of his or her assets, whether business or personal. This is known as unlimited liability.

In a sole proprietorship, one person performs all the functions required for the successful operation of the business. The proprietor secures the capital, establishes and operates the business, assumes all risks, accepts all profits and losses, and pays all taxes. The proprietor is said to be self-employed.

Advantages:

- Quick, easy to establish with low start-up costs
- Greatest freedom from regulation only requiring the necessary registration of the business and appropriate licenses to operate
- Owner in direct control of decision making
- Minimal working capital required
- Tax advantages to owner as all business expenses are deducted from personal income
- All profits to owner

Disadvantages:

- Unlimited liability
- Lack of continuity in business organization in absence of owner
- All business income is taxable and may be at higher rates than that of a incorporated organization
- Difficult to raise capital than it is for a partnership or a corporation
- Limited in terms of employee compensation plan

PARTNERSHIP

A partnership is a formal agreement in which two or more persons combine their resources in a business with a view to making a profit. Each partner contributes something towards the business; start-up money, material resources, talent and skills, experience and knowledge, or business contacts. Not all partners however may be actively engaged in the day-to-day operation of the venture.

In order to establish the terms of the partnership and to protect partners in the event of a disagreement or dissolution of a partnership, a **partnership agreement** should be drawn up. Partners also share profits and losses according to the percentages laid out in the partnership agreement. Standard form partnership agreements can also be purchased for about $5.00 at stationary stores. Partners share in the profits according to the terms of the agreement. Partnerships can be either **general** or **limited**.

GENERAL PARTNERSHIP

In a **General Partnership**, two or more owners share the management of a business, and each is personally liable for all the debts and obligations of the business as outlined in the partnership agreement. This means that each partner is responsible for, and must assume the consequences of, the actions of the other partner(s). It is registered in the same manner as a sole proprietorship. Profits or losses are usually divided according to each partner's percentage of interest or ownership in the venture and are applied to personal income for income tax purposes. If in bankruptcy one partner does not have enough personal assets to cover his or her share of the losses, creditors can file claims on the personal assets of any of the other partners in the venture.

LIMITED PARTNERSHIP

A second type of partnership is a **Limited Partnership** which involves limited partners who combine only capital. They are not involved in managing the business and cannot be liable for more than the amount of capital they have contributed. This is known as **limited liability**.

A limited partnership also involves general partners, who are involved in management. They are fully liable for the debts and obligations of the business, but may be entitled to a greater share of the profits. Silent partners, who invest money in the partnership but do not take an active part in the management of it, also may be involved in a limited partnership.

PARTNERSHIP AGREEMENT

The partnership agreement is a legal document that members of a partnership use to establish rules for their relationship and to specify the conditions that will cause the partnership to dissolve. This agreement may include:

- ✓ The time and capital each will contribute
- ✓ How decisions will be made
- ✓ How profits will be shared (percentage)
- ✓ How disputes will be resolved
- ✓ How future partners will be admitted to the partnership
- ✓ How partners can be bought out
- ✓ Terminating the partnership

Advantages:

- Ease of formation
- Low start-up costs
- Additional sources of investment capital and combines talents and other resources of partners
- Possible tax advantages especially for start-up losses
- Limited regulation
- Broader management base

Disadvantages:

- Unlimited liability for all debts and obligations incurred in the partnership
- Divided authority; possible development of conflict between partners making day to day decisions become more difficult if partners cannot agree
- Difficulty in raising additional capital
- Hard to find suitable partners
- Partners can legally bind each other without prior approval
- Lack of continuity
- Unless previously stated, the business terminates if a partner dies
- Both business and personal income are taxed; rates may be higher than those of an incorporated organization

CORPORATION

A corporation, also known as a Limited Company, is a legal entity established by corporate charter, which is separate and distinct from its members (shareholders). Each shareholder has limited liability. A creditor with a claim against the assets of the company would normally have no rights against its shareholders, although in certain circumstances shareholders may be held liable. It is recommended that legal advice be sought. This type of business can be incorporated at either the federal or provincial level.

Ownership interests in a corporation are usually easily changed. Shares may be transferred without affecting the corporation's existence or continued operation.

The following characteristics distinguish it from a partnership or proprietorship:

- ✓ Shareholders of a corporation have limited liability. Normally no member can be held personally liable for the debts, obligations or acts of the corporation beyond the amount of share capital the members has subscribed; and
- ✓ A corporation has perpetual succession because it is a separate legal entity, its existence does not depend on the continued membership of any of its members.
- ✓ The corporation is a legal entity that is able to enter into agreements, own land and property, and hold contracts and secure debts. It can also be sued and incur debts.
- ✓ A corporation is often managed by a board of directors, which is elected by the shareholders. The board of directors then appoints the president and other executives for the limited company.
- ✓ Profits of the corporation are divided amongst shareholders based upon the number of shares each person holds.
- ✓ When a corporation files the appropriate documents and gets approval to go public, its shares are publically traded at a stock exchange.
- ✓ Personal assets of shareholders cannot be claimed by creditors to cover debts or obligations that the corporation incurs, unless the shareholder has personally guaranteed a loan.

Advantages:

- Limited liability
- Possible tax advantage (if you qualify for a small business tax rate); profits can be removed from the corporation in the form of dividends
- Specialized management
- Ownership is easily transferable
- Continuous existence; day to day business is not interrupted despite the illness or death of the owners
- Separate legal entity
- Easier to raise capital
- The corporation can arrange for employee benefits such as group insurance or registered pension plans

Disadvantages:

- Closely regulated; more formal annual activities (annual general meeting, minutes, financial reporting) are required
- Most expensive form to organize due to government and legal fees, and name searches
- Charter restrictions
- Extensive record keeping necessary
- Double taxation of dividends
- Shareholders may be held legally responsible in certain circumstances
- Personal guarantees undermine limited liability advantage
- Losses cannot be used by the owner to offset personal income

FRANCHISE

Franchising is a system by which a firm expands into new neighbourhoods and towns (or foreign countries) by selling the rights to use the company's name and products to individuals. The franchising company provides training services and an advertising campaign for the purchaser of the franchise. In turn, the purchaser agrees to meet certain quality standards, provide certain products, and pay a franchise fee to the franchising organization.

Advantages:

- Smaller than usual capital investment
- Prior public acceptance of product
- Better than average profit margins
- Management assistance

Disadvantages:

- Possible high franchiser fee
- Some loss of independence
- Possible difficulties in canceling contract

REGISTERING A BUSINESS

REGISTERING A PROPRIETORSHIP OR PARTNERSHIP

Proprietorships and Partnerships are regulated by the provincial government. For information on registering a proprietorship or partnership in Nova Scotia, visit the Canada Business website: www.canadabusiness.ca.

REGISTERING A CORPORATION

You have the option to incorporate at a provincial level or at a federal level. If a company intends to carry on its activities solely in one province, provincial incorporation may be preferable. If the company wishes to expand its activities outside of its provincial jurisdiction at a later date, it must obtain an extra-provincial license from every other province in which it wishes to open an office or obtain a presence.

Under the *Canada Business Corporations Act*, any individual or corporation may receive a certificate of incorporation for any legal purpose with the exception of operating such institutions as banks, insurance companies, and trust and loan companies. In several provinces, a federally incorporated company will still have to obtain extra provincial registration to operate.

INCORPORATING A COMPANY IN YOUR PROVINCE

Incorporating can be a very involved process and it is recommended that you seek the advice and services of a lawyer and/or an accountant.

ABORIGINALS AND FORMS OF BUSINESS

Aboriginal businesses may receive tax exemptions for certain forms of business. The form of business 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. Therefore, it is necessary that Aboriginals understand the advantages to starting one form of business over another.