



ADVISORY BULLETIN

BEYOND THE BASICS - CRITICAL ISSUES FOR BUSINESS STARTUPS

In connection with the incorporation of your new business, this memorandum highlights a number of critical issues for you to consider with your legal, accounting and other professional advisors:

Tax-Deferred Asset Rollovers for Existing Businesses

- if you are incorporating an existing sole-proprietorship or partnership, the transfer of business assets and liabilities to the new corporation may trigger unintended tax consequences at a time when no cash would be available to pay for such taxes
- in these circumstances, it is important to obtain a valuation of valuable assets (such as real property and goodwill) and determine if the tax-deferred rollover provisions of the *Income Tax Act* (Canada) are available to you

Director Liabilities

- corporate directors have personal exposure for corporate and fiduciary obligations under many different federal and provincial statutes and at common law
- generally, only people active in a new company's operations should consider serving on the board; existing directors who desire to resign need to comply with corporate law resignation formalities to effectively eliminate future exposure
- director liability risk management/compliance strategies should be discussed with legal counsel prior to accepting an appointment to serve as a new director
- "D&O" liability insurance is available for private corporation directors and officers at varying degrees of premiums and coverage and should be considered in the appropriate circumstances
- to augment the availability of statutory indemnification rights, directors may consider earmarking certain corporate funds into a "directors' trust account" or other trust vehicle

Pre-Incorporation Contracts

- the founders of a new company may choose to sign written agreements with key suppliers, customers, landlords, bankers, etc., on a "pre-incorporation basis" but clearly not intending to accept personal responsibility under such "pre-incorporation" contracts
- compliance with the formalities of corporate legislation is necessary to ensure that these "pre-incorporation contracts" are properly transferred to the new company and do not remain personal obligations of the founders

Corporate Finance - Debt or Equity?

- unless necessary for some business or tax purpose, any significant personal resources required to fund startup expenses should be invested as debt/shareholder loans rather than as equity and reflected as such in the corporate records
- subject to your commercial lender's requirements, shareholder loans can usually be invested on a secured basis (by complying with applicable Ontario personal property security laws) so that founders can position a recovery of their original debt investment ahead of unsecured creditors and suppliers should the new business prove unsuccessful; often lenders will require subordinations and postponements from founders to ensure their claims cannot be satisfied before lenders' claims
- if security is taken back from a new operating company for outstanding debts to its founder shareholders, the founders should ensure that they are named as "loss payees" under applicable business insurance policies to prevent inadvertent payment of insurance proceeds to an insolvent debtor

Reimbursement for Incorporation Expenses

- keep track of all pre-incorporation marketing and administrative expenses
- if properly documented, these expenses can be transferred to the new company following incorporation and repaid at a later date from future cashflow on a tax-free basis (i.e., as loan repayment rather than as ordinary income)

Share Capital Structure and Income Splitting Opportunities

- with assistance from your professional advisors, it is possible to establish an appropriate share capital structure for the new company to maximize income splitting opportunities among other adult family members in a manner that still permits the founders to retain control over operations

Use of Family Trusts

- a family trust can operate, among other things, as a vehicle to maximize income splitting opportunities and multiply the current \$500,000 capital gains exemption among family members for qualified small business corporations while permitting the founders to continue to control business operations and maintain flexibility regarding such family members who may ultimately participate in the corporation's future operations and growth
- the appropriateness of using a family trust in any given circumstances should be considered with your professional advisors

Industry Regulations/Licensing

- the incorporation of an existing business may involve the transfer of existing industry and governmental licenses
- consider what industry-specific regulations, standards and licensing requirements may apply to your new corporation particularly if you are commencing business in an industry you are unfamiliar with; legal counsel or your local trade association can assist you in this area

Doing Business in other Jurisdictions

- the laws of other provinces/countries should be considered if you are either selling goods or services outside Ontario or if you are considering establishing a sales office or other permanent establishment in another province or country; determining what constitutes "doing business" needs to be considered on a jurisdiction-by-jurisdiction basis

- in particular, Ontario or Canadian federal corporations carrying on business in other provinces (e.g., British Columbia) are required to obtain extra-provincial registration in such provinces; the importance of such extra-provincial registrations relate, among other things, to such corporation's status to commence/defend lawsuits in such provinces

Staffing Issues

- it is strongly advisable to have written agreements with all employees and independent consultants who provide services to the new company to avoid future disputes over matters such as ownership of the work product, use of confidential information, termination expenses, non-competition restrictions, etc.
- if you are seeking to staff your business with consultants rather than employees, steps should be taken to satisfy yourself that your consultants are not "in fact" employees for purposes of employment and income tax legislation; your legal counsel can assist you in this area
- legal counsel should be sought prior to any employee terminations (regardless of whether or not a written employment agreement exists) to determine if a proposed severance package is fairly reflective of such employee's legal entitlements and thereby avoid future wrongful dismissal litigation; in particular, "for cause" terminations are becoming exceedingly difficult to justify under current Ontario employment laws and should only be considered with prior advice from legal counsel

Shareholder Agreement Considerations

- the best time to negotiate an agreement among the shareholders of a new company is at the outset
- as all business ventures have "a beginning, middle and an end", it is essential to address key issues among all shareholders relating to how the business will be run, how are major decisions to be made and what exit strategies will exist
- the out-of-pocket cost (not to mention aggravation) of a lengthy and protracted shareholder dispute will easily exceed the expense of preparing an appropriate shareholder agreement at the outset

Employment Policies

- consider adopting internal employee policies, rules and regulations relevant to your business and your industry
- in particular, with the prevalence of electronic communications, many new businesses require an e-mail privacy and communications policy; legal counsel can assist you in this area

Timing Issues - When to Incorporate?

- if the establishment of your new business does not involve significant 3rd party contractual obligations (e.g., no office lease, no line of credit, etc.) and if the founders anticipate initial start-up losses, consider deferring the incorporation process until you either become profitable and/or expect to incur significant contractual and/or other legal risk which you do not wish to assume in your personal capacity
- remember that any losses of a corporation cannot be transferred to its shareholders but only applied against future income or gains of the business

Shareholder Liability - Limited or Not?

- generally, shareholders are not personally liable for corporate obligations and are only "at risk" the value of their investment in their startup company
- shareholders may have enhanced personal exposure where either (a) they receive corporate distributions in violation of applicable corporate legislation, (b) they sign personal guarantees in favour of bankers, landlords, etc., or (c) serve as corporate directors (as discussed above)

- obtain legal advice before signing "standard" personal guarantee forms as these are often negotiable either as to scope, duration and/or financial exposure

Minute Book Maintenance

- applicable corporate legislation requires certain actions to be taken by corporate directors and shareholders annually to "maintain" the corporation and such actions require documentation in the minute book of the corporation
- an organized minute book reflecting all changes in directors, officers and shareholders as well as all payments of dividends, bonuses and shareholder loans is invaluable in the event of a tax audit or a proposed future sale of your business

Intellectual Property Considerations

- if intellectual property (whether in the form of patents, trademarks, copyrights or trade secrets) forms a key asset of your business, you need to take precautions to protect its creation, ownership, use, registration, exploitation and enforcement
- transferring all 3rd party (e.g., founders and consultants) ownership rights in key intellectual property is essential to ensuring the company "owns" these assets in its own right
- consider adopting formal IP protection strategies with legal counsel

Risk Management Strategies

- as enterprise value is created, consider strategies to insulate key assets from future business risks
- consider having the ownership of key capital/operating assets (e.g., real estate, fixed assets or intangibles such as patents or trademarks) owned in a separate holding corporation and leased/licensed-back to the principal operating company
- avoid combining several different business activities within the same corporation unless you do not mind having the assets of one business activity exposed to the associated business risks of another activity
- consider using holding corporations to the extent that surplus cash can be distributed on a tax-free basis to the holding corporation and kept in a "safe place" without having to take the funds into income at the personal level; if the surplus cash is still needed in the business, consider having "holdco" loan the funds back to the operating company on a secured basis (subject to commercial lender consent)
- professional advice is essential to structuring and implementing risk management strategies to ensure tax-deferral can be achieved and maximum asset protection leverage can be obtained over future business risks
- where the operations of the business are carried on through a number of corporations constituting part of the same corporate group, tax advice should be sought regarding the application of the "associated corporation" rules under Canadian income tax laws; these "association rules" may prevent each separate operating company within a related corporate group from having its own separate small business deduction on active business income
- consider the use of conventional business, property, casualty and liability insurance

Personal and Insurance Planning

- since the startup of a new business venture marks an important change in your life circumstances, consider if the founders of the new business and/or their spouses have current Wills and powers of attorney which would delegate decision-making authority in unforeseen circumstances such as a physical or mental incapacity, etc.; a current Will can operate to reduce estate administration taxes payable at a founders' death and a current power of attorney for financial matters/personal care will address substitute decision-making in the event of any future incapacity of the founders

- consider the advantages of life, disability and/or critical illness insurance in your new business startup; such insurance coverage can be used to fund any mandatory and/or optional share buyouts on death or disability resulting in less financial burden to the purchaser and access to immediate proceeds to the vendor (or his/her estate); you should consult with your tax advisor before implementing insurance coverage in these circumstances to fully understand the tax consequences to vendor and purchaser where insurance proceeds are received and used as a funding mechanism for shareholder buyouts

Use of "Standard Form" Agreements

- depending upon the nature of your new startup, the use of "standard form" agreements may be desirable with key customers and suppliers
- if your business involves the sale of products, consider adding standard business and legal "terms and conditions" to your typical invoice to address issues such as payment terms, security for payment, title/ownership matters, return policies, limitations on liability, product warranties, product acceptances, remedies upon payment defaults, etc.
- note that special considerations are relevant to leasing businesses which you should discuss with your legal advisors
- if your new business provides consulting services, consider using a "base form" of consulting agreement with beneficial standard provisions to be added to your usual payment terms; such standard provisions can address concerns such as scope of services, liability limitations, duration of services, work product ownership, status as contractor not employee, termination provisions, reimbursement for expenses, etc.

Prior Agreements and Restrictive Covenants

- if any contracts or agreements were signed with former employers/customers/suppliers prior to starting any new business, these agreements should be carefully reviewed with legal counsel to ensure they do not contain any enforceable restrictive provisions (for example, confidentiality/non-disclosure terms, non-competition and/or non-solicitation clauses) which may limit the permitted scope of commercial activity of the new business

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