



INCORPORATIONS - SOME LEGAL BASICS

Why Incorporate? - Some Advantages

- the company is a separate legal person; the assets and liabilities stay in the company and do not belong to the shareholders or owners as individuals; all income or losses belong to the company and it will file its own tax returns and pay its own taxes separate from its owners
- the death of the owners/shareholders will not result in the death of the corporation so the corporation has a perpetual existence
- the corporation is a very flexible vehicle
- shareholder generally have limited liability (but see below)
- certain tax advantages exist for certain Canadian private corporations
- some forms of government grants and loans may only be available to corporations not individuals

When to Incorporate? - Timing Issues

The main reason to incorporate from the outset of starting the business is to avoid personal liability.

However, one big reason to avoid incorporation relates to the utilization of start-up losses. If large start up expenses and minimal revenues are expected in the first year of business and if such business losses are desired to be used by the individual shareholders to offset their personal income, incorporation may be deferred until the business begins to earn income. Individual shareholders will not be able to personally use business losses if these losses are incurred by the corporation.

If you choose not to incorporate initially and intend to convert into a corporation later, you need to be mindful of potential adverse tax consequences. Under Canadian federal tax laws, if the assets of the sole proprietor/partnership are transferred to a corporation to enable the corporation to carry on the business, these assets will be deemed to have been disposed of by the individuals at fair market value. To defer paying capital gains or other taxes on such asset transfers, individuals should discuss potential tax consequences with their accountant and lawyer and structure the asset transfers on a tax deferred rollover basis under the *Income Tax Act*. Otherwise, such asset transfers may trigger unanticipated tax liabilities (particularly if the business has accumulated substantial increase in asset values or goodwill since startup) without the corresponding cash to pay such taxes.

Another important timing consideration involves “pre-incorporation contracts”. These are contracts which people sign “on behalf of a corporation to be incorporated”. These may be contracts to lease commercial space, assume a bank line of credit or purchase new supplies or equipment. To avoid personal liability, special rules need to be followed under corporate legislation to ensure the new company adopts the liabilities that individuals assume when they sign such “pre-incorporation contracts”. If you intend to incorporate, try if possible to resist signing any pre-incorporation contract until you have actually incorporated.

How to Incorporate? - Nuts n' Bolts

The process of incorporation in Canada involves several steps including:

- selecting a corporate name and undertaking a proper name search;
- considering whether a business trade name is also necessary to register separately from the corporate name
- determining whether you want to incorporate federally or provincially
- determining the number of directors
- considering if the corporation’s activities should be restricted
- determining the identity of the shareholders and the proper mix of share capital to allocate the rights to voting rights, dividends and entitlements on liquidation among the various shareholders
- determining the attributes of the different types of share capital
- determining whom the corporate officers should be
- adopting corporate bylaws
- appointing accountants/auditors
- selecting a financial year end
- authorizing bank account matters
- considering (with your accountant) if any personally held assets (e.g., computers, office furniture, customer lists, etc.) should be transferred to the new company
- considering how initial personal capital should be invested - equity or shareholder loans?
- considering if shareholder loans should be documented as “secured debt”
- determining the key issues for your shareholder agreement (if multiple shareholders)
- all the documents organizing the company are placed in a minute book
- the minute book will typically be maintained with your lawyer so that it can be properly maintained each year

Shareholders & Personal Liability

In some cases, shareholders may be personally exposed to the corporation's creditors beyond the value of their investment in the company's shares. For example, third parties may try and "pierce the corporate veil" and sue shareholders personally where fraud is involved. In other cases, if the company's directors pay dividends or redeem shares without complying with applicable corporate legislation, directors may be able to sue shareholders for a return of the value of the illegal dividends or redemption amounts. Also, if shareholders agree to serve as corporate directors, they may have personal exposure in their capacity as a corporate director. Lastly, some third parties (most often commercial banks) may require personal guarantees from shareholders, especially where the initial assets of the new company provide the bank with insufficient credit coverage.

Directors' Liability

Corporate directors have many obligations imposed under corporate law, other specific legislation and general common law. These duties include responsibility for managing and supervising the management of the business; acting honestly in good faith in the best interests of the corporation; exercising prudent care and diligence and avoiding conflicts between their own interests and the interests of the corporation (e.g., disclosing personal interests in corporate transactions).

Hand in hand with these duties go certain liabilities.

For example, directors can be sued personally under corporate law for:

- improper payment of dividends
- improper redemptions of shares
- liability for certain employee wages

Other areas of liability include:

- liability for environmental matters
- liability for failure to deduct and remit GST and employee source deductions

To address personal exposure as a corporate director, some risk management strategies include:

- making sure you understand your legal duties as a director
- attending all director meetings and ensuring management provides full reports to all directors
- obtaining legal advice before signing director resolutions which you do not understand
- if you are absent from a director meeting, find out what matters were approved and, if you disagree, consider whether to formally dissent in writing

- refraining from acting as a director unless you are prepared to take steps to be fully informed about all aspects of the company's business including whether employees get paid, whether source deductions have been deducted and remitted, etc.
- establishing "due diligence procedures" to ensure you take positive steps to inform yourself and get expert advice on areas of significant risk
- establishing proper corporate policies and procedures to monitor and control risks
- if in doubt, you may consider resigning as a corporate (especially in cases where you are a minority passive shareholder or an outside director without any equity in the subject company)

Shareholder Agreement Issues

If the corporation is to have more than one (1) shareholder, consideration should be given to whether a formal shareholder agreement is required. Effectively, a shareholder agreement is a comprehensive "operating manual" designed to manage the relationships among a corporation's shareholders and will address matters such as (a) voting rights and decision making, (b) exit strategies on death, disability, withdrawal from the business and (d) financing the business, etc. In the absence of a definitive shareholder agreement, shareholders in a business only have the protections of applicable corporate legislation which may not produce the desired outcome or leave the parties without a remedy to a particular conflict.

Disclaimer

The information provided in this article is intended only as a general summary and not specific legal advice to any particular reader. It is strongly recommended that readers consult with their own lawyer and/or accountant about their own particular legal and tax concerns.