One of the primary decisions when entering business is whether to operate as a sole proprietorship or a limited company. Making the right decision requires an analysis of the advantages and disadvantages of each, in relation to the circumstances.

Formation

Commencing a proprietorship is relatively simple. In most provinces, once a business name is chosen, the proprietor can immediately start operating under the business name.

Starting a limited company (a corporation) is more complex. Government regulations require certain documents and information are filed with the appropriate agency. With government approval, a corporation becomes a legal entity and can enter into its own contracts and agreements.

Cost of Maintaining

In both a proprietorship and a limited company, legal costs will arise from contracts, such as sales agreements. Basic accounting costs will also be incurred in both cases.

Since the limited company is closely controlled by regulations, costs will also result from the preparation of annual reports, corporate income tax returns, company resolutions, and minutes of directors' meetings. More formal records must be maintained for the limited company because it is a separate legal entity. For these reasons, more costs should be anticipated for a limited company.

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Liability of Owners

A proprietorship is not a separate legal entity. The owner is personally liable to the extent of all personal assets for contracts and liabilities incurred under the business name.

A limited company has a separate legal existence and its debts and obligations are its own. The owners, i.e. shareholders, are liable for company debts only to the extent of their share capital and any subrogated loans made to the company. However, in most small business instances, banks and other lenders require that the owners supply personal guarantees or pledge personal assets as security when the company is borrowing money.

If proper steps are taken, the limited liability of the owner will protect the personal assets from trade creditors should the company encounter financial difficulty. Directors and major shareholders may be held personally liable for employees' wages, company tax returns, declaring dividends, and making loans to shareholders.

Where an individual seeks to shield their personal assets from liabilities associated with a business venture, a limited company should be considered. Insurance coverage can be valuable in minimizing certain business risks. In many cases, only a combination of insurance and incorporation can adequately protect against most business risks.

Continuity of Existence

A proprietorship, not being a legal entity, ceases upon the death of the owner. A corporation, being a legal entity, continues after the death of its shareholders. Naturally, a small, closely-held corporation may be unable to continue if its owner dies, even thought it continues to exist legally.

Tax Considerations

Rates of Tax

The income of a proprietorship is taxed in the hands of the individual proprietor. Individuals are taxed using graduated rates. Therefore, the more income the business earns, the higher the effective rate of tax becomes.

A corporation, on the other hand, is taxed at a fixed rate. High earnings will not result in a rise in the effective rate of tax (in most cases).

Most small companies qualify as Canadian controlled private corporations, with a tax rate of approximately 10 per cent in 2018, 9 per cent in 2019, in Manitoba.

When a limited company pays wages to its active owner, these are deducted as operating expenses. The remaining corporate income will be taxed at the fixed corporate rate. For additional personal income, the owner will calculate the least expensive way to withdraw out of the corporation (such as wages or dividends).

Tax Deferral

A company may also provide the opportunity for tax deferral. A company deducts expenses as incurred whether they have been paid or not. Wages are taxable when paid. So the company may declare wages owing in one taxation year (deductible for tax purposes) and pay them in the next taxation year (taxable in the hands of the individual) creating a one-year deferral. In a proprietorship, earnings are taxed in the fiscal year in which they are earned.

Application of Losses

When a proprietor suffers a business loss, it may be deducted against other personal income. A limited company can only deduct such losses from income for the preceding 3 years or the succeeding twenty years. This limitation on loss application is a distinct disadvantage when early years are unprofitable. An individual may decide to work as a proprietorship initially, utilising early losses to offset other income and subsequently incorporate to obtain possible tax advantages in future years.

Employee Participation

A limited company owner may reward employees with profit-sharing, whereas a proprietor can only do so by admitting such employees to partnership – a step which may dilute and threaten control more than what is intended. Several devices are available for the limited company owner, such as non-voting shares, to reward employees without surrendering control.

Summary

In summary, the limited company has more advantages but higher initial and maintenance costs. A cost-benefit analysis is necessary to determine whether the advantages gained by creating a limited company will outweigh the extra costs.

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