TAX TALK

The basics of business structures: Sole proprietorships and partnerships

Tax Talk

Scott Taylor

It's not hard to establish a corporation in Canada, and more owner/operators are doing it because it separates their personal lives from their business. A corporation is a distinct legal entity. If it goes bankrupt, the owner/operator may be out of a job but he probably won't lose his house to cover the debts of the business.

But maintaining a corporation requires more paperwork, commitment, and expense than some people are willing or able to give. That's why the vast majority of small businesses in Canada start out as sole proprietorships or partnerships. They're quick, cheap, and easy to set up. I can go out tomorrow and be Scott Taylor's Lawn Care without any special effort or government registration whatsoever.

If you're serious about starting a company, you've probably looked into the tax, legal, and financial aspects of various types of business entities. Since most new small businesses opt for sole proprietorship or partnership, here are some general principles to keep in mind:

Sole proprietorships

A sole proprietorship is owned by one person operating as an individual ("Scott Taylor") or as a registered, unincorporated business ("Scott Taylor's Lawn Care"). As the owner, you're fully responsible for the profits, losses, expenses, and legal obligations of the business. You also assume any risk associated with it. To settle business debts or lawsuits, claims may be made against your personal assets.

For tax purposes, no business structure is simpler. You and your business are one entity. To file your income taxes, you submit an income statement (form T2124) showing your gross business income less expenses and add this net income figure to any other personal income or losses you have. Your federal and provincial taxes as well as your CPP are based on this amount.

The good news: If you have a business loss, you may be able to use it to offset income that you receive from other sources. Even GST/HST is easy for sole proprietors because registering is optional until you reach $30,000 in sales. Typically, you should register immediately when you start the business.

Partnerships

In a partnership, two or more people carry on a common business and agree to own and operate that business together. We see this a lot in trucking because so many owner/operators work with family or friends.

Like a sole proprietorship, a partnership is easy to create. You don't have to file anything with the government until you hit that $30,000 sales threshold and register for a GST/HST number. The business itself pays no income tax; instead, each individual partner is responsible for the tax on his or her share of the partnership's income or loss.

Legally, the ties that hold individual partners together are easily undone. If one partner walks away, the partnership is effectively dead. You'll have to start over and will have to re-register for a new GST number and perhaps get new bank accounts and re-sign any contracts.

What makes partnerships complicated are the personalities that can emerge when there's money at stake, especially the sharing of income.

Maybe you and your partners agree to pay one another based on your individual contributions to the business during the year. How do you decide what that amount should be? Who's to say whether each partner is pulling his weight? When times get tough, whose mortgage payment gets paid first? Even with written agreements, I can't tell you how many partnerships I've seen blow up over money, ripping families and friendships apart.

The most common partnership I see involves owner/operators and their spouse. They hope to pay less tax by splitting or sharing the business income on their individual tax returns.

It's not a bad idea as long as you're consistent. If your spouse is listed as a 10% partner one year, he or she should be at that ownership percentage every year. You can't arbitrarily change the profit-splitting formula to suit your needs. In fact, Canada Revenue Agency can revise a partner's share of the income (or loss) of the partnership to an amount that it deems reasonable.

The bigger question is do you really want to expose your spouse to the liabilities of the business? Partners are personally liable for the company's debts and obligations, and for the actions of the other partners. A legal or financial burden created by one partner will be borne by all. With your spouse as your partner, your entire family's personal assets may be on the line.

If you're starting a business, sole proprietorships and partnerships can get you up and running fast. But ask your advisor about the pitfalls, like personal liability or conflicts with a partner. They may make incorporation worth the trouble. □

@ARTICLECATEGORY:3361;

– Scott Taylor is vice-president of TFS Group, a Waterloo, Ont., company that provides accounting, fuel tax reporting, and other business services for truck fleets and owner-operators. For information, visit www.tfsgroup.com or call 800-461-5970.