TAX TALK

Starting a business?

Do some sole searching

Choosing a structure for your business is a very big deal, and your decision will have a significant effect on how you report your income, the type of returns you file each year, and how you support expenses.

In the last few columns I talked about the pros and cons of incorporating (also check out the *Tax Talk* videos I did with James Menzies at Trucknews.com/videos). It's not hard to establish a corporation in Canada, and more owner/operators recognize the tax and legal advantages of doing so. That said, most start out as sole proprietors.

A sole proprietorship is owned by one person operating either as an individual ("Scott Taylor") or as a registered, unincorporated business ("Scott Taylor Cartage").

This type of structure is quick, cheap, easy to set up, and there's no mistaking who's in charge. As the owner, you're fully responsible for the profits, losses, expenses, and legal obligations of the company. You also assume any risks. That means claims may be made against you personally in order to settle debts and lawsuits associated with the business.

Because there's no legal distinction between you as an individual and your company, it's a good idea to sit down with an accountant to outline how to keep the two separate. This conversation should go beyond basic strategies – separate bank accounts, separate credit cards – and deal with areas where the lines will naturally blur.

Paying taxes

One example: income tax reporting. As a sole proprietor, you report your business revenue as taxable income on your T1 personal income tax return. You submit a statement of business activities (form T2125) showing your gross business income less expenses (Canada Revenue Agency will accept other types of financial statements, but encourages you to use the T2125), and then 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.

Unlike an employee who has tax, CPP, and other payroll-related deductions shaved off a regular paycheque, you may have to pay your income tax and CPP contributions by installments. (The process is pretty straightforward; what trips up most new sole proprietors is budgeting for the payments).

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.

Taking on partners

When two or more people own and operate a business together, they form a partnership. Like a sole proprietorship, a partnership is easy to form. Most partnerships are governed by a written agreement setting out rules for the partners, but in fact a simple verbal agreement is all it takes. 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.

While they're simple in structure, what makes partnerships complicated are the personalities that emerge when there's money and property at stake. 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. Likewise, if one partner walks away, the partnership is effectively dead. You will 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.

The number one concern with partnerships is the sharing of partnership income. If you and your partners agree to pay one another based on your individual contributions to the business during the year, how do you determine what that amount should be? Who's to say whether each partner is pulling his weight? When times get tough, and there's not a lot of money in the pot, 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 structure 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. CRA is looking for a consistent approach: If your spouse is listed as a 10% partner one year, he or she should remain at that ownership percentage every year. You can't arbitrarily change the profit-splitting formula to suit your needs. In fact, CRA can revise a partner's share of the income (or loss) of the partnership to an amount that it deems reasonable.

In my opinion, the bigger issue is, do you really want to expose your spouse to the liabilities of the business? 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, and they may be the best choice for you. Just beware of the pitfalls, like personal liability or conflicts with a partner. They may make incorporation worth the trouble. □

– Scott Taylor is v.p. of TFS Group, providing accounting, bookkeeping, tax return preparation, and other business services for O/Os. Learn more at www.tfsgroup.com.