Business Operations: Corporation vs. Sole Proprietorship

Recent changes to the taxation of private companies have substantially reduced the benefits of operating a business through a corporation, causing some business owners to re-examine the age-old question, is it better to operate my business through a corporation or as a sole proprietor? This decision involves several factors and has far-reaching consequences and therefore should not be taken lightly. It is also important to consult with a professional advisor, such as an accountant, lawyer, investment advisor, consultant, or any appropriate combination thereof. A business can be operated through several different types of entities including sole proprietorship, corporation, partnership, joint venture or a trust. Although many businesses operate as a partnership, it is the partners that are taxable on the earnings and not the partnership itself. Accordingly, this article focuses on the two most common types of taxable business entities, corporations and sole proprietorship, and discusses the benefits and disadvantages of each.

Legal entity

From a legal perspective, the biggest difference between a sole proprietorship and a corporation is that the former is not its own legal entity; it is simply an extension of the individual operating the business, whereas a corporation is its own legal entity. For example, even though a business run as a sole proprietorship might have a different name than the individual operating that business, the business itself cannot enter into contracts, own assets, or obtain financing. This must be done by the individual operating the business. A corporation can do all those things which are facilitated by appointing or electing directors of the corporation who are authorized to enter into contracts, purchase assets or obtain financing on behalf of the corporation.

Advantages

Limited liability

The distinct legal entity that exists when a company is incorporated is one benefit to operating a business through a corporation. Assets and liabilities of a corporation are separate and distinct from those of its owners, which provides the potential for creditor protection should the business become insolvent. For example, in the event of a lawsuit against the corporation, the personal assets of the individual shareholder may be protected. In contrast, the business and personal assets of a sole proprietor may be separate and distinct from an accounting perspective; however, they may be subject to seizure by unpaid creditors. While limited liability is often touted as being a significant benefit to incorporation, individuals considering incorporating a company they will control should be aware of the limitations. Often the controlling shareholders of a private company are asked to provide personal guarantees for financial institutions, landlords or other suppliers. Should the corporation be unable to settle their liabilities, these vendors have additional protection if they can seize personal assets of the shareholders to satisfy (partially or otherwise) their personal guarantee on the debt. Also, with a lawsuit, there is the potential that the company and the shareholder (i.e. the individual) could all be named in the same lawsuit, again putting the individual's personal assets at risk.

Tax deferral

Even though recent tax changes have substantially reduced the income-splitting benefits of operating a business through a corporation, there is still a significant tax deferral advantage in doing so (although this has been hindered as well). Consider the following:

Sandra operates a small consulting business in Vancouver, B.C. that, until recently, she operated part time to supplement her regular employment earnings of $210,372 per year ($140,564 after-tax). Sandra determined that the income she earned from her regular employment was sufficient to cover annual savings goals and expenses. The income earned from her consulting business would only be for additional savings, special costs, etc. She recently landed a large consulting project and anticipates having net income (i.e. after all business expenses) from her consulting business of $300,000 for the calendar year. If Sandra decides to incorporate and operate her consulting business through that corporation, then she would have a significant tax deferral. The chart below shows the after-tax dollars available for reinvestment if Sandra operates her business through a sole proprietorship or a corporation:

	Sole proprietorship	Corporation
Net consulting income	$300,000	$300,000
Taxes payable (@49%)	($149,400)	--
Taxes payable (@11%)	--	($33,000)
After-tax income available	$150,600	$267,000

The above assumes the first $500,000 of active business income is eligible for the federal and provincial small business rate (11 per cent for 2019 in B.C.). However, even on active business income above $500,000 the B.C. rate is only 27 per cent. Compared to 49.8 per cent, the top personal rate in B.C. on income exceeding $210,372, this is still a substantial deferral. Remember though, this is only a deferral of tax, as Sandra would be taxed again on any money received from the corporation either as dividends or salary. However, recall in Sandra's case, her regular employment earnings are sufficient to cover her day-to-day needs. Provided she has no additional personal cash flow needs, the after-tax corporate dollars can remain in the company until needed. This provides Sandra (through her corporation) an ongoing tax-deferral and greater after-tax amounts to re-invest in her business or passive income-earning assets.

Flexibility

Operating a business through a corporation also provides the business owner with some flexibility in managing their affairs, including:

- Choice of year-end: Since a corporation is its own legal entity, it's directors also have the flexibility of choosing any suitable year-end date for the company, subject to certain limitations. A business operated through a sole proprietorship must operate with a December 31 year end. A corporation can choose a year-end better suited to the needs of the business, such as those related to seasonality and the availability of competent accounting and tax personnel. This might allow an opportunity to receive more timely service from a professional accountant if it is an off-peak time for them as well.
- Separate books and records: Although the books and records of a business should always be kept separate and apart from personal records, they often become muddled together. As a separate legal entity, a corporation must file its own tax return. With that, business owners may experience better control over the financial reporting of the business and help prevent personal assets and liabilities from getting mixed up with those of the corporation. This provides flexibility down the road when considering a sale of the business or financing options. Having separate records gives the owner more flexibility in making these decisions.
- Timing of remuneration: As a sole proprietor, all of the income earned by the business is taxable in the year it is earned. With a corporation, as illustrated above, there is an opportunity to partially defer the payment of tax. Remember Sandra and the consulting contract she landed giving the business $300,000 of net income. If earned through a sole proprietorship, a higher average tax rate would immediately apply. On the other hand, if the income were earned through a corporation, she could have drawn that income from the corporation over time and benefited from lower personal tax rates during the years of withdrawal. Operating a business through a corporation provides that flexibility.

Disadvantages

Corporate costs

In order to operate a business through a corporation a company must be incorporated in a province, territory or federally. Regardless of which jurisdiction is chosen, there will be costs incurred, and the amount will vary depending on the jurisdiction and whether the business owner does it themselves or hires a lawyer, corporate clerk or other professional. Also, all Business Corporations Acts require that annual minutes be maintained and, again, there are costs associated with this. With a sole proprietorship, there are significantly fewer administrative start-up and ongoing steps involved, particularly where GST/HST is not required.

Another point to remember, is that corporations continue to exist until they have been wound-up or dissolved. This process can often be cumbersome, time-consuming, and again, will likely involve additional costs. In Ontario, for example, in order to dissolve a company, you must first obtain a consent to dissolve from the Ontario Ministry of Finance and then file Articles of Dissolution within 60 days of receiving consent to dissolve. The dissolution process and costs involved will depend on the jurisdiction and complexity of the assets and liabilities inside the corporation.

Accounting and tax compliance costs

As the company is its own legal entity and taxpayer, it would need to file an annual corporate tax return which is more complex than a personal tax return. A professional is often, or should be, hired to complete this. Books and records of the company must also be maintained which might require paying a part-time or full-time bookkeeper. While this may seem trivial or unimportant, they should not be overlooked. Maintaining a clean set of books in a timely manner can allow for better decision-making based on up-to-date information. It can also help minimize errors or oversights that can eventually lead to unnecessary costs in the form of penalties, interest, additional professional fees or even bankruptcy.

Double tax

Although the tax deferral discussed above can prove beneficial, in most provinces there is a tax cost if you pay dividends to yourself (as a shareholder of the company) since you are taxed again personally on earnings already taxed at the corporate level. Recall in Sandra's case, she had no immediate personal cash needs for the earnings from her consulting business, so she could benefit by leaving money behind in the corporation and not receiving dividends. In situations where a business owner will need income generated by the business for personal needs, there will likely be a tax cost once all income is paid out as dividends. The following chart shows the total tax cost (personal and corporate) to a business owner who causes the corporation to pay out all after tax earnings as dividends:

Tax Savings (Cost) of Incorporation[1]				
	Investment Income	Capital Gains	ABI[2] for SBD[3]	ABI in excess of SBD
BC	(5.91%)	(2.95%)	(0.93%)	(0.15%)
AB	(5.97%)	(2.99%)	(0.80%)	(2.15%)
SK	(4.80%)	(2.40%)	0.57%	(1.14%)
MB	(6.94%)	(3.47%)	(1.07%)	(4.18%)
ON	(4.12%)	(2.06%)	(0.44%)	(1.89%)
QC	(3.48%)	(1.74%)	(1.01%)	(2.65%)
NB	(5.94%)	(2.97%)	(0.46%)	0.51%
NS	(6.69%)	(3.34%)	(0.48%)	(5.69%)
PEI	(7.00%)	(3.50%)	(0.70%)	(3.24%)
NL	(6.03%)	(3.02%)	0.06%	(8.53%)

[1]Top marginal rates assumed; Rates current to January 15, 2019
[2]ABI = Active business income
[3]SBD = Small business deduction
[4]In Saskatchewan, for ABI (ranging from $500,000 to $600,000) that is eligible for the Saskatchewan SBD, the tax cost is 3.01 per cent and the deferral is 30.5 per cent

While there is an overall tax savings in a few provinces, the other costs associated with operating a business through a corporation should be factored in as well. The tax cost experienced in most provinces could be viewed as a double tax and therefore some business owners often wait to incorporate at the "optimal time" when a business is generating enough income such that they don't need it all personally and they can benefit from the tax deferral. If a business owner intends to incorporate after operating as a sole proprietor, caution should be exercised as the business may have goodwill or other business assets with substantial value and little or no cost. Transferring these assets to a newly incorporated company would likely trigger tax on the gain. Although there are rules in the Income Tax Act that allow for a deferral of such tax on transfer to a corporation, there would likely be professional fees incurred which are often substantial. For this reason, it is worth giving thought to incorporating earlier even if the individual shareholder will need all the business income personally for some time.

In addition to the potential double tax discussed above, there is also a potential double tax on death. Where a taxpayer dies owning shares of a privately-held corporation, the shares are deemed to have been disposed of at fair market value and they become property of the taxpayer's estate. The tax cost to the estate is the fair market value of the shares at the taxpayer's death. Absent further planning, double taxation may be an issue as there could be capital gains tax on the deemed disposition of the shares and tax on the distribution of corporate assets (i.e. dividends) to the estate beneficiaries after death.

Conclusion

The decision to incorporate your business should examine all the factors, several of which will be specific to the business owner's personal situation. Given the various complexities and long-term consequences of incorporating a company, advice from a professional should always be sought and they should be given a complete picture of the business owner's situation. Only then will a business owner be able to make an informed decision based on all the relevant facts and circumstances.

or accounting perspective the definition of AAII is much more complex. A full and careful analysis of that definition is a starting point to protecting a corporation's access to the SBD on an annual basis. It is always prudent to consult a professional tax specialist, particularly where uncertainties exist.

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