STARTING A BUSINESS

Starting a business can feel like entering a regulatory and tax jungle without a guide. There's no doubt that Canadian business and tax laws can be complex, and the administrative burden for small business owners can be heavy, but once the initial major decisions are made, and the systems to comply with the administrative load are put in place, the prospect isn't nearly as daunting as it first appears.

Wolters Kluwer

When is it business?

Small businesses often start as a hobby or leisure activity that grow and become more and more lucrative, until the line between hobby and business blurs. As well, in today's economy of short-term contracts and part-time positions, it's not unusual for individuals to hold down a job and run a small business "on the side". Hence, the question often arises – when am I actually running a business, and what are my legal and tax obligations at that point?

Hobby or Business?

- *How much time is spent on the activity?*
- *How much effort is put into selling the product created by the activity?*
- *Is there an intention to make a profit?*
- *Is a profit being made?*
- *Is the activity of a nature that would include an element of personal enjoyment?*

Canada's revenue authority, the Canada Revenue Agency (CRA), defines a business as "an activity that you conduct for profit or with a reasonable expectation of profit". Whether there exists a reasonable expectation of profit is something which can be determined only over a period of time, often years. Similarly, the intention of the person carrying out the activity can be assessed only from the conduct of the person and the nature of the activity being carried out. There are no hard and fast rules simply because each situation is different. Everyone knows someone who expends a great deal of time and money on a hobby, but does so only for the love of the activity and is uninterested in profiting financially from their investment of time and money. That person is unlikely to be considered as being in business. However, where a person with an interest in an activity and the skills to pursue it devotes significant time and money to that activity and seeks to sell the goods or services generated by the activity at a profit (even if a profit isn't actually realized), it's fair to say that that person has probably started a business.

So you're now a business owner—what's the first step?

The first and most important decision to be made is the legal structure your business will assume. You have essentially three choices: sole proprietorship, partnership, and corporation. There is no absolute right or wrong answer here. The "best" choice is the one that best meets the legal and tax needs of your particular business and personal situation.

All income of business taxed as income of business owner at personal tax rates.

All risks assumed by owner of business, including risk to non-business assets.

No separate tax return to be filed for business.

This is the first choice of many new small businesses, and for good reason. It's (relatively) simple and cheap to set up and run, and the regulatory and filing burdens are much less than those imposed on incorporated businesses.

It is also not very difficult to start a sole proprietorship. Unless you're seeking to run the business in a name other than your own (i.e., John Smith Furniture Refinishing rather than just John Smith), you would bill clients or customers of your business in your own name. If you want to operate under a business name (i.e., John Smith Furniture Refinishing), there may be provincial registration requirements, and you should consult a lawyer to determine what those requirements are in your particular province. Generally, sole proprietorships are taxed like individuals, on a calendar-year basis. For example, the income (and losses) of the business earned between January 1 and December 31, 2013, are reported on the sole proprietor's 2013 personal income tax return, or on their T1, which must be filed by June 15, 2014. As a business owner, you will also have to file financial statements for the business or complete the forms provided by the CRA, to account for the income received and the expenses and deductions claimed by the business, and include them with your personal tax return. For most small business owners (other than those operating in specific industries like fishing or farming), the required form will likely be either Form T2124, *Statement of Business Activities*, or Form T2032, *Statement of Professional Activities*. Once eligible expenses are deducted from business income, the net income of the business is added to any other income earned by the business owner (for example, from employment or investments),

and personal income tax is paid on the total at the applicable personal rates.

The price of such simplicity is the unlimited liability faced by the business owner who operates as a sole proprietor. Unlike a corporation, a sole proprietorship is not a legal entity separate from its owner. That means that the owner of the sole proprietorship takes on all risks, and those risks extend to the owner's personal property, including his or her home. In other words, if the business owes money or has liabilities, creditors of the business can seek to have those debts satisfied by the assets of the business or by the personal property of the business owner.

Operating as a partnership

No separate tax return to be filed.

Each partner taxed on respective share of partnership income.

Unlimited personal liability for debts of partnership.

Operating as a sole proprietorship is only possible if you are going it alone. Where you have decided to go into business with others, you must usually choose between a partnership and a corporation as a business structure. If you choose to go into business in partnership with others, a written partnership agreement between the parties setting out their respective roles and responsibilities, and especially, the division of partnership revenue, is always advisable.

Like a sole proprietorship, a partnership does not pay taxes itself and does not file an income tax return. Rather, the income and deductions of a partnership are calculated, and then each partner must include on his or her personal tax return, his or her share of the partnership's income, or loss, for the year. Like the sole proprietor, each partner is also required to file either partnership financial statements or Forms T2124 or T2032.

Larger partnerships (generally, those having six or more partners) do have to file a "partnership information return". The CRA publishes the *Guide to the Partnership Information Return* (T4068) to assist in the completion of that form.

The partnership business structure generally benefits from the same advantages and suffers the same disadvantages as the sole proprietorship. The time and effort involved in setting up the partnership and complying with ongoing administrative obligations, although greater than that required for a sole proprietorship, are not that onerous. However, as with the sole proprietorship, partners bear individual responsibility for the debts and obligations of the partnership, and in addition, are generally bound by the actions of their partners.

Incorporating a business

The corporation is the most sophisticated of the basic business structures, and not surprisingly, it is the most complex to set up and operate. Unlike the sole proprietorship and the partnership, a corporation is a separate legal entity. This separate legal existence means that, generally, shareholders of a corporation are not held personally responsible for the debts or liabilities of the corporation (with one important exception, outlined later).

Separate legal entity.

Must file own corporate income tax returns.

Shareholders of corporation generally protected from liabilty for corporate debts.

Creating a corporation generally requires the services of a lawyer, as there are incorporating documents to be drafted and filed with the appropriate government authorities. It is also important to note that, if there is more than one shareholder in the corporation (where, for instance, you are starting a business with one or more other investors), it is advisable to enter into a unanimous shareholders' agreement (USA). This agreement, much like a partnership agreement, sets out the respective rights and obligations of the company's shareholders and indicates what will happen on the occurrence of certain events (i.e., the death of a shareholder or the withdrawal of a shareholder from the business). Once again, the drafting of a USA is usually done by a lawyer.

Once the corporation is established, it will have both corporate and tax filing obligations to meet. On the tax side, income earned by an incorporated business is income of the corporation, for which a corporate tax return (a T2) must be filed, and on which corporate income tax must be paid. Income earned by the corporation may then be paid out to its shareholders in the form of dividends, and to its employees in the form of salaries and/or bonuses. In all cases, the corporation must maintain a set of books recording the income and expenditures of the company. Often these records are maintained by the company bookkeeper and reviewed by an accountant, who will also prepare and file the corporate tax return. On the administrative side, the corporation will be required to maintain annual filings (the specifics of which will vary depending on the jurisdiction in which the corporation was incorporated) in order to maintain its corporate status. Such filings are usually looked after by the company's lawyer.

Generally, the biggest single advantage of the corporate structure over that of a sole proprietorship or partnership is that corporate shareholders enjoy "limited liability", meaning that shareholders cannot be held liable for the debts or liabilities of the corporation. In effect, any corporate obligations or liabilities must be satisfied by corporate assets, and not by the personal assets of shareholders. However, financial institutions which are asked to provide financing to the corporation by means of a line of credit or a loan, frequently require that major corporate shareholders (especially in a small corporation), provide a personal guarantee. This means that the shareholder guarantees that any debts owed by the corporation to that financial institution will be paid by the shareholder personally if the corporation cannot make the required payments. Significantly, the CRA also takes the position that this applies to taxes as well. Specifically, its *Guide for Canadian Small Businesses* provides that "[I]f your corporation owes taxes, and you have personally guaranteed any loan on behalf of your corporation, we will claim the amount of the taxes owing up to the limit of the loan guarantee".

Tax rates for business income

As business income of a sole proprietorship or a partnership is taxed in the hands of the business owner or the partners, such income is taxed at individual rates. Those rates vary depending on the province or territory of residence of the taxpayer, but as a very general guide, the combined federal-provincial tax rates for 2014 are set out in the chart on the following page. As the chart shows, the rate of tax which may be payable on income in any particular tax bracket may vary greatly, depending on one's province of residence. In addition, this chart will not apply to taxpayers who are resident in Quebec, as that province maintains a tax system which is not directly comparable to those of the other provinces.

Personal Income Tax Components — 2014

(Prepared from information available as of January 10, 2014)

		Basic Tax Rates	Basic Tax Brackets	Surtax
Federal[1]		15.00% 22.00% 26.00% 29.00%	$0 $43,953 $87,907 $136,270	
Provincial or Territorial	Alberta	10.00%	$0	No surtax
	British Columbia	5.06% 7.70% 10.50% 12.29% 14.70% 16.80%	$0 $37,606 $75,213 $86,354 $104,858 $150,000	No surtax
	Manitoba	10.80% 12.75% 17.40%	$0 $31,000 $67,000	No surtax
	New Brunswick	9.68% 14.82% 16.52% 17.84%	$0 $39,305 $78,609 $127,802	No surtax
	Newfoundland and Labrador	7.70% 12.50% 13.30%	$0 $34,254 $68,508	No surtax
	Northwest Territories	5.90% 8.60% 12.20% 14.05%	$0 $39,808 $79,618 $129,441	No surtax
	Nova Scotia[2]	8.79% 14.95% 16.67% 17.50% 21.00%	$0 $29,590 $59,180 $93,000 $150,000	No surtax
	Nunavut	4.00% 7.00% 9.00% 11.50%	$0 $41,909 $83,818 $136,270	No surtax
	Ontario	5.05% 9.15% 11.16% 13.16%	$0 $40,120 $80,242 $514,090	20% of tax above $4,331 + 36% of tax above $5,543
	Prince Edward Island	9.80% 13.80% 16.70%	$0 $31,984 $63,969	10% of tax above $12,500
	Quebec[1]	16.00% 20.00% 24.00% 25.75%	$0 $41,495 $82,985 $100,970	No surtax
	Saskatchewan	11.00% 13.00% 15.00%	$0 $43,292 $123,692	No surtax
	Yukon	7.04% 9.68% 11.44% 12.76%	$0 $43,953 $87,907 $136,270	5% of tax above $6,000
Non-residents[3]		7.20% 10.56% 12.48% 13.92%	$0 $43,953 $87,907 $136,270	No surtax

Notes:
1. In Quebec, federal tax is reduced by 16.5% for Quebec's abatement of basic federal tax.
2. If Nova Scotia tables a budget surplus in its 2014-2015 fiscal year, for 2014, the $150,000 bracket and 21% rate will be eliminated, but a 10% surtax on provincial income exceeding $10,000 will be reinstated.
3. Instead of provincial or territorial tax, non-residents pay an additional 48% of basic federal tax on income taxable in Canada that is not earned in aprovince or territory. Non-residents are subject to provincial or territorial rates (in this table) on employment income earned, and business income connected with a permanent establishment, in the respective province or territory. Different rates may apply to non-residents in other circumstances.

Where a business is incorporated, income of the business is taxed in the hands of the corporation, at the applicable corporate rate. Once again, rates will vary, depending on the province or provinces in which the corporation does business as well as the kind of income earned by the corporation. Generally, income from an active business is taxed at more favourable rates than passive income like investment income. As well, income earned by a Canadian-controlled private corporation, particularly income below a specified "small business threshold", enjoys preferential tax rates. It must be remembered that provincial variations and exceptions abound, especially with respect to the small business limit, and that this information can serve as no more than the most general of guidelines.

The federal and provincial corporate tax rates for business income for 2014 are as follows:

Corporate Income Tax Rates by Province — 2014 (%)

(Prepared from information available as of December 16, 2013)

All rate changes must be pro-rated for taxation years that straddle the effective date. Use the rate changes to determine rates for taxation years ending on December 31, 2010 or later.

Tax holidays may reduce or eliminate provincial tax.

In addition to income tax:

- before 2013, some provinces imposed general capital tax on corporations that had a permanent establishment there, the last being Nova Scotia, which eliminated its general capital tax on July 1, 2012 (see **Capital Tax Rates and Exemptions for 2014**); and
- financial institutions may also be subject to Part VI Financial Institution Capital Tax (see **Other Federal Corporate Tax Rates for 2014**) and provincial capital taxes (see **Capital Tax Rates and Exemptions for 2014**).

General and M&P Corporate Income Tax Rates
(for December 31, 2014 year end) (%)

The percentages shown in the table below reflect the combined federal and provincial/territorial corporate rates (general and manufacturing and processing (M&P)) for a 12-month taxation year ended December 31, 2014, on income allocated to provinces or territories. For Canadian-controlled private corporations (CCPCs), this table does not apply to:

- the first $500,000 ($425,000 in Manitoba; $350,000 in Nova Scotia) of active business income; and
- investment income.

For more CCPC rates, see the table, **Canadian-Controlled Private Corporation (CCPC) Income Tax Rates.**

		General and Manufacturing & Processing (M&P)	
Basic federal rate			38
Provincial abatement			(10)
Federal rate (before deductions)			28
General rate reduction[2] or M&P deduction[2]			(13)[1]
Federal rate			15[1] ↓
		Provincial/Territorial	Combined
Alberta		10	**25**
British Columbia[3]		11	**26**
Manitoba[4]		12	**27**
New Brunswick[5]		12	**27**
Newfoundland and Labrador	General	14 **H**	**29**
	M&P	5 **H**	**20**
Northwest Territories		11.5	**26.5**
Nova Scotia		16	**31**
Nunavut		12	**27**
Ontario[6, 7]	General	11.5 **H**	**26.5**
	M&P	10 **H**	**25**
Prince Edward Island		16 **H**	**31**
Quebec		11.9 **H**	**26.9**
Saskatchewan[8]	General	12	**27**
	M&P	10[9]	**25**
Yukon	General	15	**30**
	M&P	2.5	**17.5**

H = Tax holidays are available to certain corporations in the provinces indicated.

Notes:

1. Footnote 2 to the table, **Federal Corporate Tax Rates**, indicates when the general rate reduction and M&P deduction do not apply.
2. For recent changes to the general rate reduction and M&P deduction, see footnote 1 to the table, **Federal Corporate Tax Rates**.
3. Recent British Columbia changes are shown in the following table:

	British Columbia changes effective after December 31, 2009		
	From	**To**	**Effective**
General and M&P	11%	10.5%	January 1, 2010
	10.5%	10%	January 1, 2011
	10%	11%*	April 1, 2013*

* British Columbia's 2013 budget accelerated the rate increase to 11% by one year (the 2012 budget had announced that the increase would occur on April 1, 2014, and would be triggered only if the province's fiscal situation worsens).

Corporate Income Tax Rates by Province – 2014 (%) (continued)

4. Manitoba's general and M&P rate was scheduled to drop from 12% to 11% at a date to be determined, subject to balanced budget requirements; however, this is no longer being considered by the province.
5. Recent New Brunswick changes are shown in the following table:

	New Brunswick changes effective after December 31, 2009		
	From	To	Effective
General and M&P	12%	11%	July 1, 2010
	11%	10%*	July 1, 2011
	10%	12%	July 1, 2013

* New Brunswick repealed the legislated corporate income tax rate of 8% that was to apply on July 1, 2012.

6. Recent Ontario changes are shown in the following table:

	Ontario changes effective after December 31, 2009		
	From	To	Effective
General	14%	12%	July 1, 2010
	12%	11.5%*	July 1, 2011
M&P	12%	10%	July 1, 2010

* Ontario's 2012 budget froze the general income tax rate at 11.5%, until the province returns to a balanced budget (scheduled for 2017-18). The rate was to drop to 11% on July 1, 2012, and to 10% on July 1, 2013.

7. Corporations subject to Ontario income tax may also be liable for corporate minimum tax (CMT) based on adjusted book income. The minimum tax is payable only to the extent that it exceeds the regular Ontario income tax liability. Recent Ontario CMT changes are shown in the following table:

		Ontario changes effective after December 31, 2009		
		From	To	Effective
Corporate Minimum Tax (CMT) rate		4%	2.7%	July 1, 2010
Thresholds for CMT to apply*	Total assets	> $5 million	≥ $50 million	Taxation years ending after June 30, 2010
		or	and	
	Annual gross revenues	> $10 million	≥ $100 million	

* Thresholds apply on an associated basis.

8. Planned Saskatchewan changes are shown in the following table:

	Saskatchewan changes effective after December 31, 2009		
	From	To	Effective
General	12%	10%*	To be determined*

* Saskatchewan's 2013 budget deferred the province's general corporate income tax rate decrease to 10% (from 12%) until it is "affordable and sustainable, within a balanced budget." The province is no longer committed to reducing the rate by 2015 as had been announced in its 2012 throne speech.

9. The general rate (12% in 2014) is the maximum Saskatchewan rate. A rebate of up to the difference between the general rate and 10% (2% in 2014) of manufacturing profits allocated to Saskatchewan is available.

Note that the amount of income eligible for the provincial or territorial small business rate will vary by jurisdiction.

What about GST?

Businesses usually don't like to collect GST, and no one likes to pay it. Nonetheless, GST is a fact of Canadian business life and virtually every Canadian business has to deal with it. GST is payable (and therefore chargeable) on most goods and services sold in Canada. Businesses which charge and collect GST (with the exception of "small suppliers" whose total sales are less than $30,000 a year) must register for GST purposes, and must remit a percentage of GST collected to the federal government, in addition to accounting for GST collected and remitted on their goods and services tax return.

The business number—getting started

Perhaps in recognition of the frustration level of business owners dealing with income tax accounts, GST accounts, payroll accounts and a multiplicity of other administrative obligations, the federal government has attempted to make things somewhat easier by using a system in which corporate income tax, import-export, payroll deduction, and GST matters can be handled under a single "business number". The business number system applies to both incorporated and unincorporated

(i.e., sole proprietorship and partnership) businesses, and the process of acquiring a business number is quite straightforward.

Once again, the CRA publishes a guide – *The Business Number and Your Canada Revenue Agency Accounts* – which outlines the steps involved in getting a BN.

More questions

There are a vast number of resources available to help the new small business owner. The web sites of most financial institutions and accounting firms include information for the small business sector. In addition, the CRA issues a great number of publications and guides of help to small business owners. Virtually all those publications are available on the Agency's website – http://www.cra-arc.gc.ca, which also contains much helpful information on a variety of topics of interest to small business owners. If you have general questions which are not answered by the web site information, or you have a question or a problem with your specific business account, the Agency maintains a toll-free Business Enquiry Line (1-800-959-5525) at which you can speak to a CRA client services representative.