Business Entities: An Introduction

Types of Business Organization

How you advise your business clients will depend not only on their personalities, motivations and goals, but also on the type of business involved. The type, or legal form, will impact everything from funding and taxation to insurance and how the owner's death will affect the company.

This guide will introduce you to the three major types: sole proprietorship, partnership and corporation. It will outline their defining characteristics and describe common insurance needs.

As you progress through the guide, think of business owners with whom you are already acquainted. What category do their businesses fall into? Is the legal form appropriate for what the owner wants to achieve? How does this affect their insurance needs? How does your new understanding of each category change your opinion of how you would advise them?

Sole Proprietorship

This is the simplest way to set up a business. In a sole proprietorship, one owner makes all the business decisions and earns all the profits. The owner is personally responsible for all of the debts and obligations incurred by the business—he or she has unlimited liability.

It is likely that sole proprietorships are a large potential market for you. Their insurance needs are very similar to those of individuals and families. You'll find that owners of this type of business tend to be very approachable. They are used to relying on outside advisors to help with many areas of their business, and they will often welcome your input.

- **Advantages and Disadvantages**

Since this is one of the simplest types of businesses to establish, it is also the most common. However, as you'll see from the chart below, there are both advantages and disadvantages to the sole proprietorship structure. Understanding how the structure helps or hinders the owners will increase your ability to offer appropriate advice.

Advantages to Owner	Disadvantages to Owner
- Low start-up costs - Greatest freedom from regulation - Owner in direct control of decision making - Minimal working capital required - Tax advantages to owner - All profits to owner	- Unlimited liability - Lack of continuity in business organization in absence of owner - Difficult to raise capital - Owner to absorb all losses
Insurance considerations - Life of company is limited to life of legal owner - On death, business passes into owner's estate with other personal assets	

- **Additional considerations**

The main feature of a sole proprietorship is that the business itself is not a separate legal entity from the owner of the business. Legally, the owner's personal and business financial matters are indistinguishable. You will find that if you are comfortable working with the family market, you will be comfortable working with sole proprietors. Their needs are very similar.

Business liquidation and family retention of the business are important issues for this group. For example, many business owners in this group think it would be a good idea to pass the business on to offspring who work with them. However, very few take steps to make their wishes a reality.

When working with sole proprietors, it is always good idea to help them understand that they *can* have say in what happens to their business—and that you can help make sure their wishes are followed.

Partnership

A partnership is more complicated than a sole proprietorship both to establish and to run. To begin, a partnership involves an agreement between two or more people carrying on a business with a view to making a profit. There are built in strengths to a partnership—the pooled assets of the partners, for example—as well as built-in weaknesses (i.e. if anything happens to one partner, the viability of the business can be called into question).

There are two kinds partnership to remember:

- **General Partnership:** Two or more owners share the management of a business. Each is personally liable for all the debts and obligations of the business. Each partner is responsible for, and must assume the consequences of, the actions of the other partner(s).

- **Limited Partnership:** The partners combine only capital. They are not involved in managing the business and cannot be held liable for more than the amount of capital they contribute. This is known as limited liability.

A few additional characteristics of partnerships include:

- A written agreement forming and defining the partnership is preferable, but it is not legally necessary. However, the partnership name must be registered.
- In a general partnership, all partners are fully liable for all expenses and debts of the partnership. The liability goes beyond contributed cash or other assets to include all personal assets as well.
- The partnership itself pays no taxes. An information return that details the income, expenses and profits of the partnership must be filed each year. The profits are allocated proportionately among the partners, who report income on their own personal income tax returns.
- Individual partners can make legal commitments that are binding on all the partners.

- **Advantages and Disadvantages**

Advantages to Owner	Disadvantages to Owner
- Ease of formation - Low start-up costs - Additional sources of investment capital - Possible tax advantages - Limited regulation - Broader management base	- Unlimited liability - Divided authority - Difficulty in raising additional capital - Hard to find suitable partners - Possible development of conflict between partners - Partners can legally bind each other without prior approval - Lack of continuity
Insurance considerations - Life of partnership ends with winding up of affairs following dissolution on death of any partner (unless there is a prior agreement) - On death of one of the partners, business is automatically dissolved and must be liquidated and reorganized (unless there is a prior agreement) - Deceased partner's interest passes to his or her estate	

- **Additional considerations**

The interdependence of the partners is both a strength and a weakness for a partnership. While it allows the partners to pool their talents and resources, it also means that if something happen to one of the partners, the survival of the partnership may be in question.

Because the structure makes it easy for the company's founders to see how much they rely upon each other, partnerships offer a good opportunity for producers. They can work to show the partners how to use insurance and proper planning to protect the business, themselves, and their families.

When working with this group, you will typically find yourself recommending insured buy/sell agreements, partnership purchase agreements and insurance funding.

Private Corporation

This is the stage at which business insurance begins to get more complicated (and more interesting!). Unlike sole proprietorships and partnerships, corporations have a separate legal existence apart from the shareholders of the corporation.

Also known as a Limited Company, a corporation is a legal entity that is separate and distinct from its members (shareholders). Each shareholder's liability is limited to the share capital contributed. A creditor with a claim against the assets of the company would normally have no rights against its shareholders, although in certain circumstances shareholders may be held liable.

A corporation is formed by registering (incorporating) either provincially or federally.

- **Advantages and Disadvantages**

There are several features that that make incorporation the favored legal structure for many businesses. These include:
Limited Liability: A primary advantage to incorporating a business is the limited liability conferred upon its shareholders. The shareholders are not liable, in most cases, for the debts and other obligations of the corporation. A shareholder's liability for the debts of the corporation is limited to the amount of funds that shareholder invests in the corporation. Creditors only have rights against the corporation itself, not against the shareholders.
Perpetual Existence: A corporation is not dependent upon the life of its shareholders and will not be affected by changes in, deaths or retirements of its members. This allows for the orderly transfer of ownership of the corporation (i.e., its shares). In addition, due to its independent legal status, a corporation may own property in its own right, enter into contracts and sue (or be sued).
Capital Acquisition. A corporation can access greater potential sources of capital than other business forms (such as sole proprietorships and partnerships). Corporations can issue various classes of shares (in addition to other debt instruments such as bonds) to raise capital, which, typically, is more attractive to investors.
Tax Advantages. There are tax advantages to incorporating a business. These include lower income tax rates and the ability to carry forward losses of previous years to offset profits in subsequent years.
Credibility: Incorporation can give a company credibility and prestige.

Advantages to Owner	Disadvantages to Owner
- Limited liability - Possible tax advantage (if you qualify for a small business tax rate) - Specialized management - Ownership is transferable - Continuous existence - Separate legal entity - Easier to raise capital	- Closely regulated - Most expensive form to organize - Charter restrictions - Extensive record keeping necessary - Double taxation of dividends - Shareholders may be held legally responsible in certain circumstances - Personal guarantees undermine limited liability advantage
Insurance considerations - No limit on lifespan of corporation. Period of legal life is perpetual, unless limited by terms of charter, bylaw or statute. - On death of owner, business continues its independent legal existence, with the deceased stockholder's shares passing to his or her estate and through it to heirs unless there is an agreement to the contrary -	

- **Additional Information**

Advising members of a corporation calls for comprehensive understanding of business insurance and taxation issues. You can obtain additional information from the following sources:

- Advocis (www.advocis.ca)
- Business Insurance Program
- CLU Program

There are also a number of excellent books on the topic, including:

- *Tax Guide for Investment Advisors, 2003* by John R. Mott, published by Carswell
- *Canadian Small Business Handbook*, by Susan Kennedy-Loewen, published by Key Porter Books
- *Guide to the Family Business, Canadian Edition 2003*, by Peter Leach, Bruce Ball, C.A, and Garry Duncan, C.A., published by Thomson Carswell
- *Planning for Business Owners and Professionals*, 8th Edition, by Ted Kurlowicz, James F. Ivers III, and John J. McFadden, published by The American College

Quick Reference Guide

Issues	Sole Proprietorship	Partnership	Corporation
Creation/Organization	- Easiest to set up - Often no formalities	- Voluntary agreement of two (or more) parties - Written agreement preferable	- By consent and authorization of the law - Must comply with statutory formalities
Relation of Owners to Business	- One and the same - Personal and business assets are merged	- Association of owners, managed by general partners - Business is conducted in the firm's name - Partner acts as principal for self and agent for associates - Assets may be in firm's name, but partners are co-owners as tenants in partnership	- Business and its shareholders are separate entities - The corporation is a legal unit itself, capable of owning its own assets and acting in its own right - Managed by directors and officers
Owners' Liability	- Complete liability	- Complete liability, but with the right to have firm assets first applied to firm debts, and with rights of contribution between partners	- Limited to capital contribution unless shareholder personally guarantees the corporate debt
Profits	- All belong to the individual owner	- Shared equally unless there is a special agreement otherwise	- Shared indirectly through dividends declared by the directors out of the profits