Incorporating your Business – Tax Implications and Share Structuring

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As discussed in our previous newsletter, there are many factors to consider when determining whether or not to incorporate your business. In many cases, business owners don't incorporate their business immediately, but rather delay until it becomes more established. In this newsletter article we will discuss how to transfer your current business operations to a corporation, and matters to consider when structuring the corporation's shareholdings.

ASSETS TRANSFERRED TO A CORPORATION

You may not have incorporated your business when it started, but things are going well and you wish to take advantage of one or many benefits of incorporating your business. Common sense would say that you would transfer all of your business assets to the corporation and begin operating out of the corporation, however, without taking proper steps on the transfer, you could unknowingly walk into an unfavourable tax bill! Under the Income Tax Act, a corporation is a separate legal entity from the individuals that own it, and all transactions between related parties must take place at fair market value (FMV). Absent filing any tax elections, if an individual sole proprietor transfers a business asset that has fair market value in excess of its cost for tax purposes (generally its original purchase price, less any depreciation already claimed), this would result in a taxable event to the individual. This applies not only to tangible assets, but also the business's goodwill, which is the additional amount that an unrelated buyer would pay to acquire the intangible value of your business, possibly as a result of strong business connections, processes, existing contracts, history of profitability, etc.

Fortunately, there is an income tax election available to allow business owners to avoid paying tax on the transfer of most assets to a corporation, by deeming them to dispose of the assets for as low as the tax cost. Known as a subsection 85(1) election, this election effectively defers the tax liability until the corporation sells the asset in the future. While most taxpayers elect to transfer their assets at their tax cost to avoid incurring any immediate tax, a thorough review of your personal circumstances can reveal tax saving opportunities by forgoing all or a portion of this tax deferral.

STRUCTURING THE SHAREHOLDINGS

In order to complete a subsection 85(1) election (as discussed above), the business owner must receive shares as consideration for the assets they transfer into the corporation. There are many factors to consider when deciding the type and number of shares to be issued. Shares can have many different attributes, and share structures are commonly tailored to meet the specific needs of the shareholders. Questions to ask are:

- Should the shares be entitled to participate in the future growth in business value, or should their value be limited?
- Should the shares have voting rights?
- Are the shares eligible to receive dividends? If so, will the dividends be fixed in value, or completely discretionary?
- Under what circumstances can the shareholder or corporation require the shares be redeemed?
- Should you hold the shares directly, or via a holding company?
- If there are multiple shareholders, should a shareholder's agreement be entered into? This would govern how future circumstances will be dealt with, such as when a shareholder no longer wants or is able to be involved in the business.

OTHER CONSIDERATIONS

There are many other tax matters to consider on incorporation, including tax elections related to GST/HST and accounts receivable, and unique structuring considerations if any of the shareholders are U.S. citizens or green card holders.

When deciding how best to incorporate your business, your Roth Mosey advisor can help you every step of the way. We can provide you with advice regarding valuation of goodwill, tax implications on the transfer of assets, share structuring considerations, and review of legal agreements to assist you with the process. Speak with your Roth Mosey advisor to learn more about incorporating your business, and the tax opportunities available to you.

ABOUT THE AUTHOR

Alan Valihora, CPA, CA
Tax Manager

Alan is currently a Tax Manager and provides guidance in the areas of personal and corporate tax planning, preparation of corporate, personal, and trust tax returns, estate and succession planning, and assisting with the cross border tax implications of individuals and corporations with Canadian and U.S. filing requirements. Alan also assists clients in the development of business plans, financial projections, and applications for government assistance.

Alan joined Roth Mosey & Partners as a co-op student in 2011, received his Honours Bachelor of Business Administration degree from Wilfrid Laurier University in 2012, received his CPA, CA designation in 2015, and completed CPA Canada's In-Depth Tax Course in 2017.

Questions?

Contact Alan
D: 519.962.5925
E: avalihora@rothmosey.com