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Business Organizations in Ontario, Canada:

Sole Proprietorships
General Partnerships
Limited Partnerships
Corporations

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January 2010

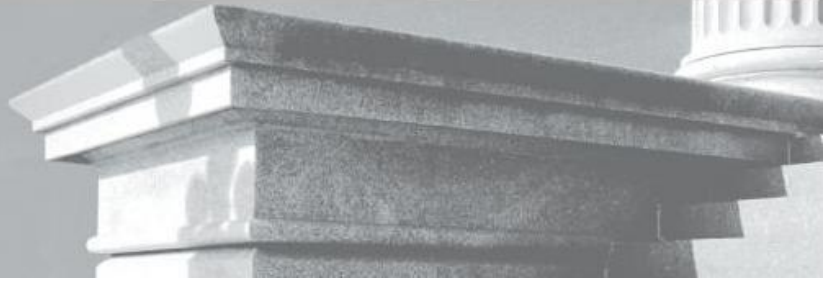


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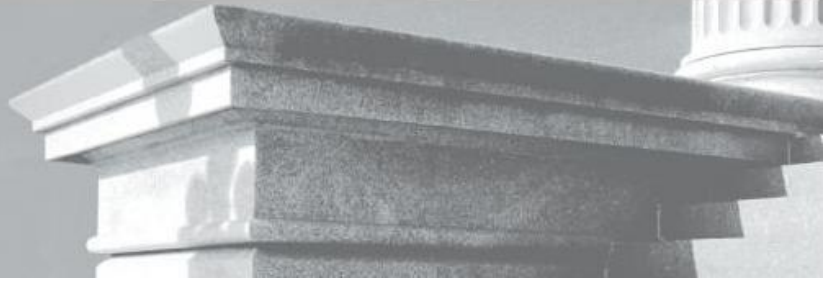
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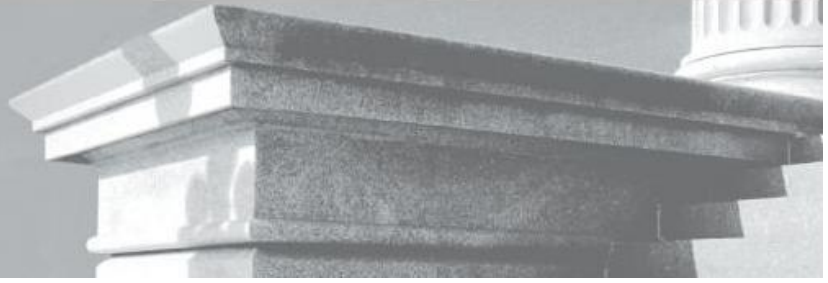
Introduction

You want to start your own business. Or perhaps you have an existing business structure but want to make a significant change (e.g. by adding partners or shareholders). You're not entirely sure what the different business structures are available, but you've heard their names: **Sole Proprietor**, **General Partnership**, **Limited Partnership**, and **Corporation** (there are others too – such as professional corporation, franchise, joint venture, association, independent contractor, etc. – but we won't be getting into those in this eBook). So what exactly are these business structures? How do you go about creating, maintaining, and ending them? What are the advantages and disadvantages when it comes to liability, decision-making, tax, and other issues?

These and other questions are common, but not always answered. Sometimes, a lack or absence of communication can result in costly mistakes and even litigation. That's why we come up with the idea of writing this eBook. Through it, we hope to shed some valuable insight into these and other questions that may come to mind when you're getting serious about structuring a legal business in Ontario, Canada. Remember: if you're looking for an Ontario lawyer to help you with your business law needs, make a post on [Dynamic Lawyers](#). We have Toronto, Ottawa, Hamilton, Brampton and other Ontario lawyers registered who can assist you in drafting, reviewing, revising, or resolving disputes concerning business agreements and structures. I should know – I'm one of them. You can contact me directly at michael@carabashlaw.com.

Sole Proprietorships

If you are the sole owner and operator of your business, then you are carrying on as a sole proprietor. This unincorporated legal structure involves just one human being running the show. There is no separate legal existence between the person and the business. The sole proprietor has complete control over the work, the finances, the marketing, and engaging others.



Advantages

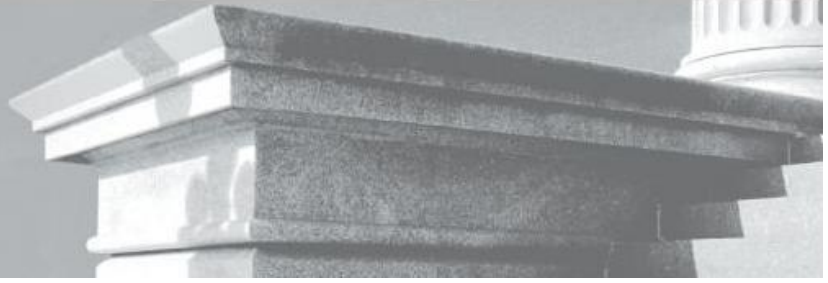
The advantages of running a sole proprietorship include:

- Making all decisions;
- Reaping all profits;
- Working how and when you want to;
- Having more client contact;
- Being flexible;
- Personal satisfaction of achieving success through your own knowledge, skills and experiences.

Disadvantages

The disadvantages of running a sole proprietorship include:

- Being all alone
- Lacking specialization
- Succumbing to financial problems;
- Not being able to handle large or complex matters;
- Having responsibility over all administrative details;
- No expense sharing or income-balancing with partners;
- Isolation; and



Ease of Creation

By far, creating a sole proprietorship is easier than creating any other type of business organization. Ontario's *Business Names Act* provides that "[n]o individual shall carry on business or identify his or her business to the public under a name other than his or her own name unless the name is registered by that individual". Registering a sole proprietorship's name can be done by completing and submitting an on-line application for a **Master Business License** to:

Companies and Personal Property Security Branch
Ministry of Government Services
393 University Ave., Suite 200
Toronto, Ontario M5G 2M2

The cost is \$60 and the Master Business License must be renewed every 5 years at a cost of \$60.

Continuity

If a sole proprietorship's owner stops working (e.g. retires, dies, goes bankrupt, etc.), then the business will cease to exist. In other words, a sole proprietorship has no continuity above and beyond the owner's.

Liability

The owner is exposed to unlimited personal liability for the sole proprietorship's debts and obligations. That being said, a sole proprietor will not incur liability as a result of anyone else's actions or omissions (which may be the case with a partnership).



Taxation

Income earned by a sole proprietorship flows to the owner, where it is fully taxed at the owner's personal income tax rate. Despite this downside, the owner will be able to offset losses and business expenses from the sole proprietorship or any other source of income (e.g. businesses or property) against his or her personal income from any source of income. The fiscal year end for the sole proprietorship will be the same as for the individual owner – namely, December 31st of each year.

General Partnerships

Ontario's *Partnerships Act* governs general partnerships. A general partnership is “the relation that subsists between persons carrying on a business in common with a view to profit”. Here, the word “business” includes “every trade, occupation and profession”. You may need to consult with a lawyer to determine if you're already involved in a partnership (without even realizing it!). In these situations, you may be subject to the Ontario's Partnerships Act and other legislation.

Advantages

The partnership structure offers the advantage of having someone to brainstorm your cases with, share the expenses, and expand your database of clients. Partnerships typically generate a great deal more money than sole practices. Advantages include:

- shared financial risk;
- continuity of cash flow (e.g. when you are on vacation or ill);
- ability to discuss all files with your partner;
- additional sources of capital and clients;
- broader management base;
- division of labour;
- ability to diversify your products / services; and
- sharing cost of associates and support staff.



Disadvantages

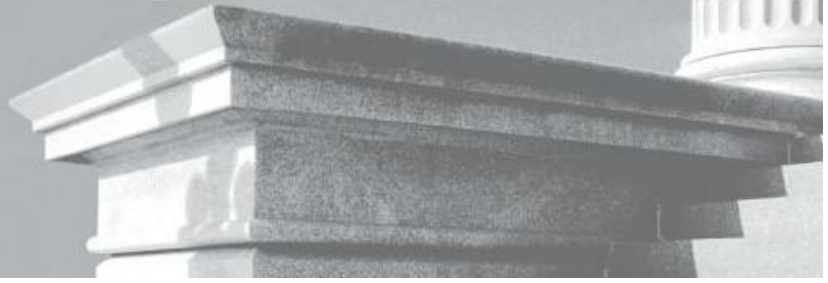
The disadvantages to having a general partnership include:

- hard to find suitable partners;
- divided authority;
- conflicts among partners;
- liability for partners' actions; and
- less freedom to choose clients.

Ease of Creation

Ontario's *Business Names Act* provides that "[n]o persons associated in partnership shall carry on business or identify themselves to the public unless the firm name of the partnership is registered by all of the partners". In addition to registering the general partnership's name in the same manner as a sole proprietorship's, the partners will generally enter into a partnership agreement to modify the default rules prescribed by the *Partnerships Act*.

This partnership agreement will usually outline the relationship of the partners to each other and to third parties. The partnership agreement will also deal with issues such as the term of the partnership, who the partners are, how the partnership's assets will be managed, capital contributions if any, how profits are to be shared, how the partnership is to be managed, liabilities and disability insurance, admission and withdrawal of partners, how the partnership is to be run and mechanics for dissolving the partnership.



Continuity

A general partnership can only terminate in one of four general ways. First, a partnership can end by notice or by a contractual term in the partnership agreement: **ss. 26 and 32**. Second, a partnership can terminate by death, insolvency, charge on a partner's share or illegality of business: **ss. 33 and 34**. Third, a partnership can be terminated by court order: **s. 35**. This method of dissolving a partnership requires that an application be brought for one of the following reasons:

1. One of the partners is found to be mentally incompetent;
2. One of the partners becomes permanently incapable of performing his or her part of the partnership;
3. One the partners has been guilty of conduct that prejudicially affects the carrying on of the business;
4. One of the partners willfully or persistently permits a breach of the partnership agreement or otherwise so conducts him or herself in a manner relating to partnership business that it is not reasonably practicable for the other partners to carry on the business partnership with him or her;
5. When the business of the partnership can only be carried on at loss; or
6. When in any circumstances have arisen that in the opinion of the court render it "just and equitable that the partnership be dissolved".

Liability

In a general partnership, all partners are jointly and severally responsible for the liabilities of the partnership up to the total value of their personal assets.

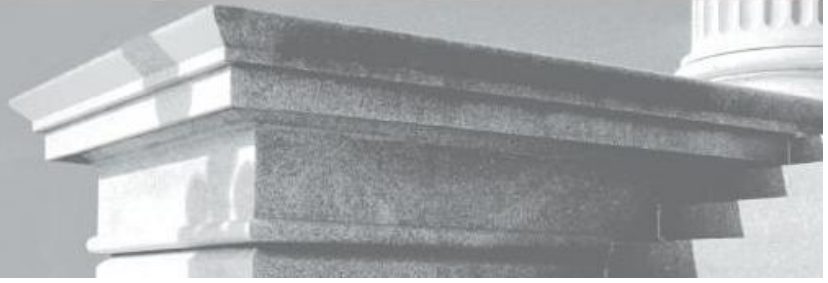
Taxation

A general partnership is a flow-through entity, which means that income earned by the partnership is passed onto the partners without being taxed at the partnership level. If a partnership earns dividend income, taxable capital gains, or realizes a business loss, these sources would be received as dividend income, taxable capital gains, or business losses in the hands of the partners. The income, losses, and tax credits of the firm is first determined and then allotted to the individual partners in accordance with their equity interest in the partnership (as per the partnership agreement). The income earned by the individual partners will be fully taxed at their personal income tax rate.

Partnership Agreement Issues / Considerations

You should make sure that your lawyer addresses some (if not all) of the following issues when drafting and negotiating a partnership agreement:

1. Date.
2. Description of partners.
3. Partnership name.
4. Terms of partnership — insert date of commencement, otherwise date of signing governs.
5. Place of business.
6. Description of business.
7. Percentage or amount of contribution to capital.
8. Division of net profits — in absence of agreement, partners share equally, therefore, include provision for periodic review and criteria or basis for revising interests.
9. Accounting and other records.
10. Auditor.
11. Fiscal year.
12. Accounting principles.
13. Banking arrangements.
14. Restrictions on partners and partners' liability for personal obligations.
15. Provision as to whether partners are to devote full time and attention to the business.
16. Management.
17. Partnership contracts — who signs the contracts?
18. Partners' drawings.
19. Retirement, bankruptcy or death of a partner.
20. Non-competition clause.
21. Sale of partnership interest by partner to third party.
22. Expulsion of partner.
23. Grounds for dissolution.
24. Admission of a new partner.



25. Purchase options: (a) Obligation to purchase by the continuing partners on retirement, expulsion or death of a partner or (b) Option to purchase by successors from continuing founder.
26. Valuation of a partnership interest.
27. Partnership property — is property registered in firm name or name of one or more partners.
28. Limitation of liability of general partners to limited partners (if limited partnership).
29. Insurance provisions.
30. Arbitration of disputes.
31. Requirement that partners enter into marriage contracts with spouses.
32. Registration — provision must be made for requisite registration under the *Business Names Act*.
33. Statement of governing law.
34. Enurement and binding effect.
35. No assignment.
36. Notices.
37. Counterparts.
38. Signed and sealed.

Let's take a look at some of these issues in greater detail, shall we?

Date

This is important because, at the end of the agreement, there will typically be a provision saying that the agreement comes into force on the date first written above. So be sure to put a date at the beginning!

Parties

Here you want to be very clear as to who the parties are that are entering into the general partnership. Use full legal names and address. Keep in mind that residency of the partners is important for tax purposes: if there is one partner who is considered to be a foreign resident under the Canada *Income Tax Act*, then the partnership cannot be considered a “**Canadian partnership**” for tax purposes: s. 102(1). This is an interesting provision because it allows the CRA to essentially look through the partnership vehicle (keep in mind that it's a flow through entity and not a separate legal person) to see who the partners are.

If one of the partners is a non-resident of Canada, then the partnership is not a “Canadian partnership”. This has a number of significant impacts. First, this non-resident status effectively denies a rollover (i.e. tax deferral) on partner transfers of certain property into the partnership (s. 97(2)); these rollovers are available only to “Canadian partnerships” in the form of an election.

Second, non-resident partnerships are denied a rollover (i.e. tax deferral) on partnership property that is distributed to the partners on the dissolution of the partnership (s. 98(3)); again, these rollovers are available only to “Canadian partnerships”. Third, pursuant to ss. 212(1) and 212(13.1)(a), if a non-resident partnership pays an amount that is deductible to it under the Act to a non-resident partner, then the non-resident partner will be required to withhold 25% taxes on designated income (e.g. management fees, interest, rents, royalties, dividends, etc.) which it receives from the non-resident partnership! Ouch! Finally, non-resident partners may be liable to pay Canadian withholding taxes (e.g. 25%) when they dispose of certain taxable Canadian property (e.g. shares of Canadian companies, Canadian real estate, certain partnership and trust interests, etc.): s. 116(5). Therefore it’s important for tax purposes to know who the partners are and whether they are residents of Canada.

If you’re dealing with a corporate partner, be sure to get a lawyer to do the diligence on whether the corporate partner properly exists and has all the necessary powers and approvals to enter into the partnership.

A common question comes up: can a general partnership be a partner of a general partnership? The answer is “NO”. General partnerships are governed by the Ontario *Partnerships Act* and the written partnership agreement between the parties (which can override certain default rules of the Act). That *Act* states in s. 3 that a partnership is entered into between “persons”. Unfortunately, “persons” is not defined in that *Act*. So we turn to s. 29(1) of the Ontario *Interpretation Act*, which defines a person to include “a corporation and the heirs, executors, administrators or other legal representatives of a person to whom the context can apply according to law”. Since there’s no reference to a “partnership” as being a “person” capable of entering into a “partnership” under s. 3 of the *Partnership Act*, a general partnership cannot be a partner of a general partnership! Phew...I hope you follow that logic!

Partnership Name

You need to specify here what the partnership name will be. It is this name that the partnership must carry on business using. You might want to do name searches to make sure that the partnership name is not being used or not used in your industry. Furthermore, you may want to consider trademarking the name to better protect it. The Ontario *Business Names Act* creates two requirements for partnership names under ss. 2(3) and 2(3.1):

2(3) No persons associated in partnership shall carry on business or identify themselves to the public unless the firm name of the partnership is registered by all of the partners.

2(3.1) No persons associated in partnership shall carry on business or identify themselves to the public under a name other than a firm name registered under subsection (3) unless the name is registered by all of the partners.

Let's be clear here: the consequence of failing to register a partnership name does not mean that a partnership never existed. A partnership's existence will depend on the test set forth in section 3 of the Ontario *Partnership Act* and the court's interpretation of that section. This is to be distinguished from a limited partnership, which can ONLY exist upon the registration of the limited partnership name!

Place of Business

Identifying the place of business is important for record-keeping purposes. Partners have rights to inspect partnership documents and records (e.g. financial records, etc.). As such, there should be a clear indication of where the primary place of business or head office is located for the purpose of allowing partners to inspect and make copies of these records.

Business of the Partnership

Here, you'll want to identify the business of the partnership (e.g. you can specify that the partnership will carry on the business of X for X in the geographic region of X). It's important for a couple of reasons.

First of all, non-compete clauses and other restrictive covenants generally use the "Business of the Partnership" as defined in the partnership agreement as the basis to limit partners' ability to compete during and after the term of the partnership agreement. Just make sure a lawyer review this so that it is properly defined (i.e. broadly enough or narrowly enough, depending on what the partners' particular interests are).

Second, the business of the partnership – properly defined – should help limit the scope of a partner's authority to bind other partners. This is important because partners may sometimes act outside the scope of their authority (e.g. beyond the defined "business of the partnership"); if it can be said that the partner acted within the scope of the "business of the partnership" (based on a factual matrix), then one partner may inadvertently bind the other partners and make them liable for that partner's acts and omissions. That's why it's good to have a clearly written and agreed-upon "business of the partnership" and to have it reviewed to ensure compliance!

Why is it so important? Take the following example (the leading case in Ontario). In *McDonic v. Hetherington*, 96 O.A.C. 289, 29 B.L.R. (2d) 1, 142 D.L.R. (4th) 648 (Ont. C.A.), two clients (sisters) sued a lawyer and his law firm partners in respect of investments which the lawyer had been making on their behalf. The law firm had a substantial mortgage business and regularly invested funds for its clients. The lawyer (without the other partners knowing) made investments on behalf of the sisters without telling them about the nature of the investments he was making, getting their approval, or protecting their interests. But that lawyer used the law firm's facilities, services, and employees to transact that business. The sisters sued the lawyer and his law firm partners for negligence and breach of fiduciary duty (among other things). The Ontario Court of Appeal found the partners liable because that one lawyer's activities were WITHIN the scope of the law firm's ordinary business and were performed within the implied or apparent authority of the partners. The Court of Appeal found there was nothing to suggest to the clients that the lawyer was acting in any capacity other than as a partner of the law firm. The fact that the lawyer acted negligently or dishonestly or that partners weren't aware of any of his business dealings didn't matter! As such, the other partners were jointly and severally liable (judgment was: \$10,198 for one sister and \$231,557 for the other sister plus legal costs!) under the Ontario Partnership Act for the acts of that one partner. This goes to show that partnerships should be mindful of the business carried on by the partners!

Finally, the "business of the partnership" should likely be one of those clauses that requires the unanimous consent of all the partners to change it because of its importance.

Capital Contributions

Capital contributions are assets (e.g. money, etc.) that the partners put into the partnership to help get the business on its feet (e.g. by paying for start-up costs and working capital). In the absence of an agreement, partners must contribute equally. Section 24.1 of the Ontario *Partnerships Act* only says that: "All the partners are entitled to share equally in the capital...of the business...[and]...must contribute equally towards the [capital] losses..." It's important to note that partnership agreements may want to include from the onset the obligation on partners to contribute capital in the future (e.g. at regular intervals). Since a partnership is simply a flow through structure and does not have a separate legal existence from the partners who make it up, it cannot retain and reinvest earnings. That's why it's a good idea to force partners to contribute additional capital from time to time. This can be done, for example, by having the partners agree to reinvest a % of profits in the partnership business, maintain a reserve, or identify circumstances which would require specific amounts or percentages of capital to be contributed and when.

It's worth mentioning that partners who transfer property to a Canadian partnership (and where all the partners so jointly elect) can do so on a tax rollover basis: s. 97(2) and 85(1) of the Canada ***Income Tax Act***. This means that property can be transferred at elected values instead of at fair market value (which may have tax implications).

Division of Net Profits

In the absence of an agreement, partners are entitled to share equally in the partnership business' profits: s. 24.1. In typical partnership agreements, the partners will agree to divide the net profits as per their capital contributions. Remember: profits are only paid if there's anything left after paying expenses. That's why it's important for the partners to agree that, in a fiscal year, expenses and losses of the partnership will be paid out first and if there isn't enough assets and income in the partnership business to offset those expenses and losses, then the partners will contribute in proportion to their partnership interest. You may want to think about including a provision that requires periodic review of the division of net profits and the basis for revisiting partnership interests in profit. For example, a partner who spends a great deal of time on non-billable administrative items (e.g. human resources management, information technology management, accounting, taxes, marketing management, etc.) may be rewarded with a higher interest in profits – perhaps even higher than their capital contribution.

Accounting and Other Records

Partners or their legal representatives are entitled to request and receive from other partners true accounts and full information “of all things affecting the partnership”: s. 28. To help clarify what these “things” are, the partnership agreement should describe the nature of records, statements, books, etc. that are kept in the partnership (and where they will be kept). The records should be sufficiently detailed for tax, legal, and business purposes. Finally, you'll want to make sure that you include a statement in the partnership agreement that requires that unfettered access to all records, data, accounts, and information stored electronically (by means of a computer, etc.) be given to all the partners and their legal representatives at all times.

Fiscal Year

Picking a fiscal year is not as straightforward as one thinks. For accounting purposes, you should consult with an accountant or auditor to determine an ideal fiscal period for reporting. For example, if your business is cyclical or seasonal, you may want to select a certain year end that helps to smooth income. Be sure to seek advice!

For tax purposes (remember that partnerships must file an annual partnership information return after their fiscal period), the combined effects of ss. 96(1) and 249.1 of the Canada Income Tax Act make it clear that the fiscal period will be determined by the type of taxpayers (e.g. individuals, corporations, etc.) that make up the partnership group. If any member of the partnership is an individual, then the fiscal year end must generally be the calendar year end (with certain limited exceptions). If all of the members of the partnership are corporations, then the fiscal year end can be anytime so long as the fiscal period does not exceed 53 weeks: s. 249.1(1)(a).

For all of your partnership agreement needs or if you would like to get quotes on basic or complicate partnership agreement templates, go to [Dynamic Lawyers](http://DynamicLawyers.com) and make a post (it's free and anonymous and there's no obligation to go with a specific lawyer).

Limited Partnerships

A limited partnership is a partnership governed by statute and any governing documents agreed to between the parties (e.g. limited partnership agreement). We begin our analysis with the Ontario *Limited Partnerships Act*. Section 3(1) of that *Act* states that a limited partnership must consist of at least one person who is a GENERAL partner and one person who is a LIMITED partner. And there can be more than one of each. A general partner is essentially like a partner in a general partnership, which I have blogged about extensively. They have all the rights and powers to manage and bind the limited partnership. Importantly, their liability is **UNLIMITED**. Think of a limited partner, on the other hand, kind of like a silent partner. They don't get involved in controlling the business of the partnership and their liability is generally LIMITED to the value of money and other property which they contributed or agreed to contribute to the limited partnership: s. 9.

Creation

Interestingly, unlike general partnerships (which can come into existence without the partners being aware or even specifically trying to avoid that relationship), a limited partnership can only come into existence “when a declaration is filed with the Registrar”: s. 2(2).

A limited partnership is a statutory vehicle. Granted, it is a partnership (i.e. two or more people carrying on business together with a view to a profit). But it is governed by the *Act* and any limited partnership agreement (just as a general partnership would be governed by the Ontario Partnerships Act and any partnership agreement). And to be a limited partner in a limited partnership, you must deliberately file a **Declaration** and pay a fee (e.g. \$210 in Ontario) to create a limited partnership. So you can’t accidentally have a limited partnership. And you can’t assume you are a limited partner with limited liability without first achieving that status under the Act.

So what about the liability of a limited partner until that happens? Well, until the declaration is filed and accepted by the Registrar, the partnership can only be characterized as a general partnership, which imposes UNLIMITED liability on the prospective limited partner.

Also worth mentioning is that you need to have a partnership before you can have a limited partnership. This means that the basic test for forming a partnership must exist at all times – namely, that one or more parties carry on business in common with a view to profit (see s. 3 of the Ontario *Partnerships Act*). In *Backman v. R.*, [1997] T.C.J. No. 728, the Tax Court of Canada cited *Pooley v. Driver* (1876), 5 Ch. D. 460 and *Stekel v. Ellice*, [1973] 1 W.L.R. 191 to support the proposition that a “partnership” must exist under the *Act* in order to create a limited partnership in Ontario:

74 Therefore, the mere act of registration does not create a limited partnership. As one commentator has noted in the context of the Ontario *Limited Partnerships Act*:



While the Ontario legislation provides that a limited partnership is formed when a declaration is filed with the registrar in accordance with the legislation, this provision does not appear to dispense with underlying requirement that there be a partnership embodying a relationship between persons carrying on business with a view to profit. In other words, registration of a limited partnership will not of itself create the relationship of partnership. Registration simply confers limited liability in respect of the limited partners and renders the partnership subject to the additional provisions of the Act.

75 Members of a purported limited partnership must share a view to profit in order for their arrangement or relationship to be considered a partnership for the purposes of the *Act*.

When that case was appealed, the Federal Court of Appeal made the following comments about Alberta *Limited Partnerships Act* (which is akin to the Ontario *Limited Partnerships Act*):

52 However, I do not read these provisions as giving the limited partnership some type of existence independent of the requirement to comply with the definition of partnership.

53 I see nothing in the limited partnership provisions of Part 2 [of the Alberta *Limited Partnerships Act*] that renders the definition of partnership inapplicable to limited partnerships...

Renewal

Every 5 years, a limited partnership declaration must be renewed and payment (currently \$210) must be made to the government. The renewal requires:

- that all general partners sign;
- that the limited partnership name be provided;
- that the address of the principal place of business in Ontario be provided; and
- that the general nature of the business be identified.

If the answer to these questions changes from the previous limited partnership declaration, then a declaration of change must be filed with the registrar.

Name of Limited Partnership

A few things are worth mentioning here about the name of the limited partnership. First, if the partnership is going to operate under a business name other than the owner's, then the business name must be registered under the Ontario *Business Names Act*. The appropriate form [can be found here](#) (for now). Second (VERY IMPORTANT): if the surname or a distinctive part of a corporate name of a limited partner is used in the limited partnership's name, then "the limited partner is liable as a general partner to any creditor of the limited partnership who has extended credit without actual knowledge that the limited partner is not a general partner": s. 6(2) of the Ontario *Limited Partnerships Act*.

Limited partners losing their limited liability status

So we start off with the idea that limited partners are generally liable only to the extent of their contribution. Their contribution must be stated in the records of the limited partnership and such records must be kept at the limited partnership's principal place of business in Ontario: s. 4.

Limited partners have a number of rights in the limited partnership (same as general partner) under the Ontario *Limited Partnerships Act*, including:

- the right to inspect and copy the books of the limited partnership (s. 10(a));
- the right to be given a complete and formal account of the limited partnership's affairs (s. 10(b));
- the right to obtain dissolution of the limited partnership by court order (s. 10(c));
- the right to share in the profits and other compensation of the partnership (s. 11(1)(a)), subject to other provisions of the *Act*;
- the right to have their initial contribution returned (s. 11(1)(b)), subject to other provisions of the *Act*;
- the right to examine the "state and progress" of the limited partnership business and advise as to its management (s.12(2)(a));
- the right to act as a contractor for or an agent or employee of the limited partnership or of a general partner (s.12(2)(b));
- the right to act as a surety for the limited partnership (s.12(2)(c)).

As discussed above, if the surname or a distinctive part of a corporate name of a limited partner is used in the limited partnership's name, then "the limited partner is liable as a general partner to any creditor of the limited partnership who has extended credit without actual knowledge that the limited partner is not a general partner": s. 6(2) of the Ontario *Limited Partnerships Act*.

Even more importantly: if a limited partners "takes part in the control of the business" of the limited partnership, then they shall be fixed with the same UNLIMITED LIABILITY as a general partner: s. 13(1). Keep in mind that a limited partner, simply by exercising their other rights and powers granted to them under the *Act* (i.e. above), will not assume the liability of a general partner. Such liability only attaches to them exercising control beyond the scope of what they are allowed to under the *Act*.

So what have the Ontario courts said about this whole "takes part in the control of the business" situation? Well, at present, the leading case in Ontario is *Haughton Graphic Ltd. v. Zivot*, 33 B.L.R. 125 (Ont. H.C.J.), aff'd 38 B.L.R. xxxiii (Ont. C.A.), leave to appeal denied 38 B.L.R. xxxiii (S.C.C.). Here are the facts of the case:

- The Defendants wanted to launch a magazine to be published in the U.S.
- They represented to a printing company that they were the president and vice-president of a limited partnership under Alberta Law.
- A deal was struck for the printing company to print the Toronto magazine. In late 1982, it printed the first five issues.
- The limited partnership went into bankruptcy, leaving the printing company unpaid for the printing of three issues.
- The printing company decided to sue the limited partners personally to get its money back.
- Importantly: one of the defendants had incorporated a business and made it the general partner of the limited partnership. That defendant controlled the corporation. That corporation employed both defendants.

So the question in that case came up: should the limited partners – in their personal capacity – be held liable for debts owed by the limited partnership on the basis that they took part in the control of the business? The court was looking at Alberta laws of limited partnership, which were akin to s. 13 of the Ontario *Limited Partnerships Act*.

The Ontario High Court of Justice essentially said (if I may paraphrase): “Yes, they’re liable”. Eberle J. said that the defendants were “in complete control of the limited partnership”: one defendant was the directing mind of the limited partnership, was responsible for it, and managed it. He signed cheques on behalf of the limited partnership (the other defendant had authority to do so). The fact that they were both employees of the general partner did not save them.

What’s also important in this case is that the Court rejected the defendant’s arguments that they shouldn’t be liable on the basis that the printing company knew it was dealing with a limited partnership. The idea here is that a limited partner who takes part in controlling the business shouldn’t be liable if the creditor believes that the limited partner was a general partner. But the court rejected that argument. Eberle J. stated that that: “If reliance was a necessary precondition to unlimited liability for a limited partner, appropriate words should be in the statute”.

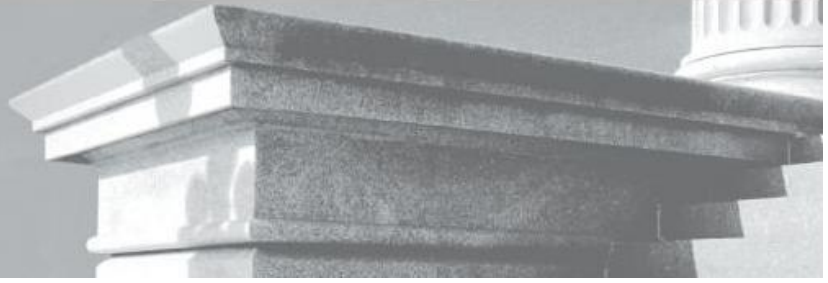
So what’s the moral of the story? Be cautioned: if you’re both a limited partner and an officer or director of a general partner, **your liability will be unlimited** if you take part in the control of the business – even if you claim you did so in your capacity as an officer or director of a general partner and not as a limited partner!

Separate Legal Entity?

Just so we’re clear, I thought it would be a good time to ask: is a limited partnership a separate legal entity from its partners? **The answer is “no”.**

A limited partnership is a type of partnership governed by the Ontario *Limited Partnerships Act*, the Ontario *Partnerships Act*, and the limited partnership agreement that exists between the general and limited partners (if any). There is nothing that confers on a limited partner the status of being a separate legal person.

With these things being said, there are a number of legal situations where a limited partnership appears to be a separate legal entity. For example, a limited partnership:



- can sue and be sued;
- can file its own income taxes;
- can be petitioned into bankruptcy; and
- has its own property (for the purposes of dissolution and redistribution);

But don't get confused: these instances are mere conveniences granted by statutes to a limited partnership to recognize it temporarily for various purposes (e.g. civil litigation, tax, bankruptcy, etc.). Always remember that a limited partnership is simply a special kind of partnership that is not a separate entity from its partners. Think of it like a marriage between persons...

Securities laws implications

When limited partnerships are being established, it's not just a matter of complying with the provincial partnerships acts, the *Income Tax Act*, and any partnership agreement that may exist between the partners. If the limited partnership is going to be offering "securities" (as defined under the Ontario *Securities Act*) through the offering of limited partnership interests that fall under that definition, then the limited partnership will need to comply with dealer registration, prospectus requirements, and other onerous obligations before it is allowed to offer those securities. The limited partnership can, however, avoid complying with the dealer registration and prospectus obligations if it qualifies for an exemption. You should definitely consult with a business lawyer familiar with these exemptions BEFORE offering limited partnership interests. Also keep in mind that you'll need to comply in ALL of the jurisdictions you're proposing to offer securities. So you'll need to consult with lawyers about compliance in those jurisdictions (and the rules are not necessarily the same wherever you go!). All too often, parties don't think about complying with securities laws until it's too late. Then it's only down hill from there: Ontario *Securities Act* proceedings which could result in worse things (e.g. civil litigation, bankruptcy, divorce, etc.). OUCH!!!

Tax considerations

Ontario limited partnerships are generally used for tax planning purposes. A group of persons want to start a business. They realize that the business will generate losses in the first few years (which is normal when you're first starting out). They want to offset their income with those losses. If they use a corporation, the losses will get trapped in the corporation. The corporation can carry them forward (to a certain extent), but cannot transfer those losses through dividends to the shareholders. Since a limited partnership is simply a flow-through structure and not a separate legal entity, its losses can be attributed to its partners. So, to recap: Ontario limited partnerships are generally used for tax purposes (since they offer no advantages to mitigate liability vis-a-vis a corporation).

I have previously blogged about limited partnerships NOT being separate legal entities from the partners. Partnership income, losses, assets, and liabilities are all attributable to the partners. As per the Canada *Income Tax Act*, partnerships do not file separate tax returns. They file **Annual Information Returns** setting out their income and details of the partners who are entitled to that income. It is the partners who are required to pay income tax. The limited partnership is simply a flow-through entity. So to recap: the net income of the partners (for income tax purposes) of a limited partnership is determined by figuring out the net income of the limited partnership.

To figure out the net income of the limited partnership, the *Act* says that you look at it as if it were a separate legal person: **s. 96(1)(a)**. So you include income and deduct allowable expenses and other credits. Then, the limited partnership's income will be attributed to the partners (usually as per the limited partnership agreement). Each partner must report their income or losses from the partnership and pay taxes accordingly: **s. 96(1)(f)**.

It's important to note here that the *Act* doesn't just allow partners to determine the allocation of their partnership interests as they wish. There are two important restrictions here under **ss. 103(1)** and **(1.1)**:

103. (1) Where the members of a partnership have agreed to share, in a specified proportion, any income or loss of the partnership from any source or from sources in a particular place, as the case may be, or any other amount in respect of any activity of the partnership that is relevant to the computation of the income or taxable income of any of the members thereof, and the principal reason for the agreement may reasonably be considered to be the reduction or postponement of the tax that might otherwise have been or become payable under this Act, the share of each member of the partnership in the income or loss, as the case may be, or in that other amount, is the amount that is reasonable having regard to all the circumstances including the proportions in which the members have agreed to share profits and losses of the partnership from other sources or from sources in other places.

(1.1) Where two or more members of a partnership who are not dealing with each other at arm's length agree to share any income or loss of the partnership or any other amount in respect of any activity of the partnership that is relevant to the computation of the income or taxable income of those members and the share of any such member of that income, loss or other amount is not reasonable in the circumstances having regard to the capital invested in or work performed for the partnership by the members thereof or such other factors as may be relevant, that share shall, notwithstanding any agreement, be deemed to be the amount that is reasonable in the circumstances.

So basically, **s. 103(1)** says that, if the “principal reason” for the partnership allocation may be “reasonably considered” for the purpose of reducing or postponing tax, then the *Act* will re-allocate partnership interests to what is “reasonable in the circumstances”. Meanwhile **s. 103(1.1)** says that non-arms length persons (so it doesn't apply to arm's length persons) have a partnership allocation that is not “reasonable” with respect to the partners' respective capital contributions, work performed, etc., then the *Act* will re-allocate partnership interests (once again) to what is “reasonable in the circumstances”.

Fiscal Year End

For tax purposes (remember that partnerships must file an annual partnership information return after their fiscal period), the combined effects of **ss. 96(1)** and **249.1** of the Canada *Income Tax Act* make it clear that the fiscal period will be determined by the type of taxpayers (e.g. individuals, corporations, etc.) that make up the partnership group. If any member of the partnership is an individual, then the fiscal year end must generally be the calendar year end (with certain limited exceptions).

If all of the members of the partnership are corporations, then the fiscal year end can be anytime so long as the fiscal period does not exceed 53 weeks: **s. 249.1(1)(a)**.

At Risk Rules

Generally, limited partnerships have been used as flow-through investment vehicles for the limited partners to realize and capture losses of a start-up business in its first few years. They are beneficial structures because they give investors limited liability (so long as they are limited partners) while allowing losses to be directly attributable to the partners. It's typical to see the general partner receive a fee for managing the limited partnership while the limited partners receiving the lion's share of flow-through income/losses.

So we start off with the idea that losses of a limited partnership are directly attributable to the limited partners in proportion to what the limited partnership agreement says. But there are exceptions to this general statement (as noted above). And there are additional limits on the extent to which **limited** partners can deduct these losses. The *Act* says that limited partners can only deduct limited partnership losses up to their "At Risk" amount at the end of the fiscal year. The "At Risk" amount is more or less what it means: partners can only deduct losses according to a calculation that measures their risk in the limited partnership.

Here's how it works under **ss. 96(2.1) and (2.2)**:

1. Add the adjusted cost base of the limited partner's interest at the time of computation;
2. Add the the partner's share of income of the partnership for the current fiscal period;
3. Subtract all amounts owing by the partner to the limited partnership or to a person with whom the partnership does not deal at arm's length with; and
4. Subtract any amount or benefit which tends to reduce the investment risk to the limited partner.

If there is an excess in this calculation (i.e. a limited partner's share of losses is greater than their "at risk" amount), then this amount could be carried forward indefinitely (but not backwards) if certain requirements are met: **s. 111(1)(e)**. Again, it's best to speak with an accountant and a lawyer to find out more about the tax treatment of limited partnerships.

Who is a limited partner?

First, an Ontario limited partner is one of two types of partners required to form a “limited partnership” under the Ontario *Limited Partnerships Act*. The other type of partner is called a general partner. Unlike a general partner, a limited partner’s liability is limited up to their contribution (a general partner’s liability is unlimited).

Contribution of limited partners

The biggest distinguishing factor in being a limited partner is that generally your liability exposure is limited to your contribution. What is their contribution, then? Well, it’s not services. It must be money, property or both: **s. 7(1)**. Just like with the “Stated Capital” of a corporation, the limited partner’s contribution must be recorded in the limited partnership’s books. For those who don’t know, the “Stated Capital” is a simple document that shows, with respect to a corporation, who its shareholders are, how much they’ve given the corporation for their shares, the number and class of shares they own, etc. You get the point. But what’s important to note about the limited partner’s contribution to the limited partnership is that ANY PERSON has the right, under the Act, to inspect the records of the limited partnership at the registered head office (or the limited partnership’s attorney’s office) during normal business hours AND may make copies of and take extracts! Failure to comply could constitute an offence under the act and be punishable on conviction to a fine of up to \$2,000 (for an individual) or \$20,000 (for a corporation).

Transferring limited partnership interest

The *Act* says (at **s. 18(1)**) that a limited partner’s interest is assignable. Well, that’s a good thing. But there’s an important caveat: is the limited partner a “substitute partner”? If no, then the assignee (the person acquiring the limited partner’s interest) will ONLY be entitled to receive the assignor’s (the limited partner) contribution to the limited partnership and share of the profits or other compensation. OUCH! What about rights to inspect the limited partnership’s records and books or be given information or account about matters affecting the limited partnership? Nope. Sorry. No rights there! So says **s. 18(3)** of the Act.

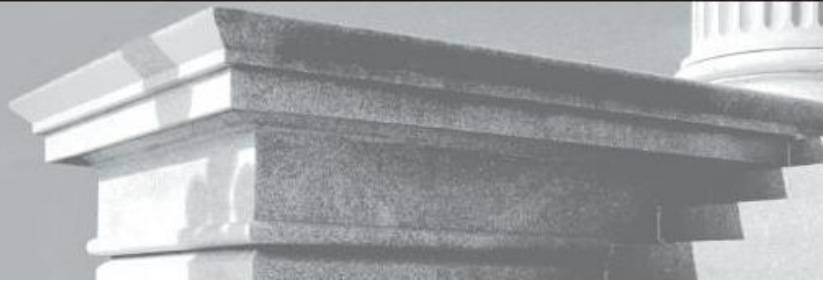
So what is a “substitute partner” and what kinds of rights and duties, etc. do they enjoy after receiving or being assigned the interest of the limited partner? Well, a “substitute partner” is an assignee who either receives permission from all the other partners in writing to be a “substitute partner” or who is designated by the assignor (i.e. the limited partner) under the authority of the limited partnership agreement.

OK, so what happens when an assignee becomes a “substitute partner”? Well, essentially they have all the rights and powers and are subject to the same restrictions, duties, obligations, etc. as the limited partner who assigned their interest. There are a few points worth mentioning here. First, the “substitute partner” will not inherit or be subject to the liabilities of the limited partner which weren’t known at the time the limited partner became a limited partner and which could not be ascertained from the partnership agreement, the declaration or the record of limited partners. Second, the assignor (limited partner) will not, even in assigning their interest, be relieved of their obligation to pay for any difference between their actual and recorded capital contribution (**s. 16 of the Act and s. 18(7)**). Furthermore, the assignor (limited partner) will not, in assigning their interest, be relieved of liability arising from false or misleading statements in the partnership record that they were aware of but did not take steps to correct (**s. 30 and s. 18(7)**).

Who cannot use a Limited Partnership?

In Ontario, professionals such as lawyers, doctors and accountants cannot use a limited partnership vehicle: they are prohibited from doing so. They can, however, form a professional corporation or a limited liability partnership – a discussion of which shall be reserved for another blog.

Look, I know this stuff gets confusing – particularly if you’re not a lawyer – so if you want to talk with a lawyer about limited partnerships, being a limited or general partner, setting up or dissolving a limited partnership, etc., then make a post on [Dynamic Lawyers](#) or [contact me directly](#).



Corporations

Not many people realize this, but corporations are creatures of statutes. The theory is that citizens vote in politicians, who in turn create legislation, which is then used by citizens to create corporations to limit their liability, gain access to capital, expand their business, etc.

Advantages

Some of the biggest advantages to operating a corporation include:

- Tax benefits and tax deferral through the small business credit and the lifetime capital gains exemption to qualifying small businesses;
- The ability to raise capital through a security issuance (e.g. equity or debt);
- The prestige factor that goes along with having a “Corporation”;
- The ability to income split through dividends and hiring family members for employees (this assumes you’re paying them a fair and reasonable amount for their services); and
- An owner / operator can choose his or her salary and dividend mix in order to minimize tax exposure.

Disadvantages

- Relatively high start-up costs and ongoing maintenance costs (e.g. accounting, meetings and minutes, payroll, and taxes); and
- Creating and maintaining a separate bank account, letterhead, business and tax numbers, etc.

Incorporation

A corporation, as a creature of statute, is created through the filing of **Articles of Incorporation**. This is the name of the document that must be submitted to the Federal or Ontario Government (depending on which jurisdiction the corporation wishes to fall under) to create a corporation. A corporation is a separate and distinct legal entity from its incorporators and from its owners, managers, employees, etc. A corporation has its own rights and obligations; must file its own taxes (at both the provincial and federal levels); has its own income, assets, and liabilities; and can be sued and sue other parties.

These things being said, a corporation must act through other parties (e.g. owners, managers, employees, directors, etc.), who can in turn be held liable for their actions (e.g. negligence, breach of contract, etc.), although the corporation will likely be sued in these circumstances because of things like vicarious liability, insurance, and its otherwise deep pockets.

The Articles of Incorporation must provide the following information to be valid (s. 6 of the *Canada Business Corporations Act*):

1. The name of the corporation;
2. The province in Canada where the head office of the Corporation is to be situated;
3. The classes and any maximum number of shares that the corporation is authorized to issue (and the characteristics of such shares);
4. If the issue, transfer or ownership of shares of the corporation is to be restricted, a statement to that effect and a statement as to the nature of such restrictions;
5. The number of directors or the minimum and maximum number of directors of the corporation; and
6. Any restrictions on the businesses that the corporation may carry on.

The Articles of Incorporation may also set out additional provisions permitted by the Act or by law to be set out in the corporate by-laws (for the purpose of this blog, I won't get into this here).

With respect to the different classes of shares, it's always best to keep things simple: most small private companies have two classes of shares (one preferred and one common) and have the ability to issue an unlimited number of shares, but only issue common shares. The preferred shares are left for estate freezes and other tax-savings structures for the shareholders (which I won't get into here).

Organization

But simply submitting and having the government approve of your incorporate package is not sufficient to have your company up and running. In fact, the cheap incorporation companies out there that promise to incorporate your company may not help you establish by-laws (which are power-giving or authority-giving documents that make corporate actions legal), prepare director and shareholder meetings and minutes (which establish accountability and transparency by letting stakeholders know what was decided upon), and finish explaining each party's (i.e. shareholders, directors, officers, employees) roles and responsibilities vis-a-vis the corporation. Knowing how to incorporate is a good start, but it's always wise to consult with a business lawyer (e.g. by making a post on [Dynamic Lawyers](#)) with respect to questions about these and other things corporation related. A lawyer can provide these and other documents in the form of a **Minute Book**.

A **Minute Book** is just a compendium of documents that help organize the corporation. It doesn't have to be in any particular form. It's more like a binder than anything else where you can slip in the following (usually in this order):

- Incorporation Certificate;
- Articles of Incorporation;
- By-Laws of the Corporation;
- Consents to Act as Directors;
- Resolutions and Meeting Minutes of Director and Shareholder Meetings;
- Register of Directors (this shows who has been a director, when they were a director, and their address);
- Register of Shareholders (this shows the class of share and number of shares issued to a particular shareholder);
- Stated Capital (which shows the number of issued and outstanding shares);
- Share certificates (these are the pieces of paper which show who owns the shares in the corporation); and
- Corporate seal (although it is not formally required, a corporation may use a corporate seal which may have a logo and its name on it to stamp on documents for business purposes).

Shareholders, Directors, and Officers

A corporation is created by having the initial directors file articles of incorporation in the jurisdiction in which the corporation is going to have its head office (provincial licenses will also be required to operate the corporation in particularly provinces). After this, the directors have got a few things to do to get the corporation organized and up and running. For example, they will need to pass a By-Law (which gives the corporation's directors power-making authority), pass director resolutions, issue shares to shareholders (and have the shareholders subscribe to shares), have the shareholders ratify the by-law, have the shareholders vote in the new directors, etc. Without these essential steps and documents, a corporation is not a legally operational entity.

Directors

The board of directors is comprised of individuals and typically a chairperson who oversee the affairs of the corporation, but not typically on a day-to-day basis. The directors are sometimes paid to sit on the board, but it's not a lot of money because they don't meet that often and are not responsible for the day-to-day affairs of the corporation. The directors themselves may have expertise in various areas and sit on a number of corporate boards. They offer their insight and are accountable to the shareholders who vote them in.

Shareholders

For their part, shareholders are the owners of the corporation and have the power to vote in the directors of the corporation. If there is only one sole shareholder holding all of the shares of the corporation then that person could vote in all of the directors. It is possible to have only one shareholder and one director of a corporation.

Officers

Finally, officers of a corporation are appointed by the board of directors in order to oversee the day-to-day management of the corporation's affairs. The titles of officers are not that important, although traditionally most people have come to know officers as one of the following: President, Chief Executive Officer, Treasurer, Chief Financial Officer, Secretary, Vice-President, etc. It does not really matter what these individuals are called. Often, their titles, roles, and responsibilities will be outlined in a corporate by-law, which establishes their position and sets out their qualifications, powers, duties, etc. Officers can be replaced by the board of directors, to whom they are accountable.

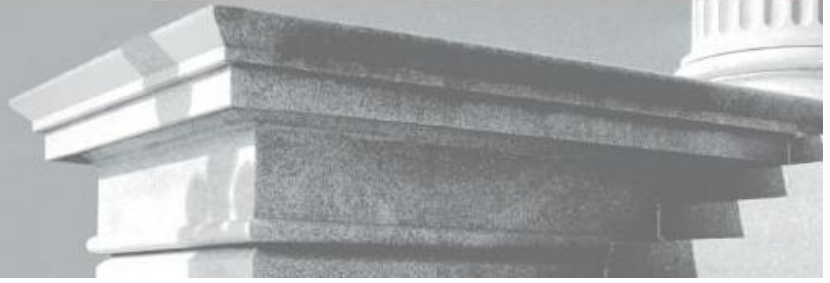
So to summarize: shareholders with voting power will vote in the directors on an annual basis (or sooner in certain circumstances), directors have the power to manage the corporation and they meet only a few times a year, and officers (e.g. CEO, VP, CFO, Treasurer, President, etc.) are the people who run the corporation on a daily basis and who are appointed (not elected) by the directors on an annual (or sooner in certain circumstances) basis.

Piercing the Corporate Veil

Limited liability companies are business that have been incorporated under a particular jurisdiction (e.g. Ontario, Federally) and which have a separate legal existence from their incorporators, shareholders, managers, and employees. They are called limited liability companies because the personal liability of the shareholders is limited; only in limited circumstances will a court pierce or lift the corporate veil to impose personal liability on the corporate shareholders.

Specifically, courts have found that the following situations may warrant the lifting of the corporate veil and the imposing of personal liability on shareholders:

1. **Sham/Cloak/Conduit/Alter Ego:** Where there is a controlling shareholder or a one-man company, the shareholder may be held liable through the principal / agent theory: whenever anyone uses control of the corporation to further his own rather than the corporation's business, he or she may be liable for the corporation's acts.
2. **Tort claims:** The veil may be pierced in cases which are fundamentally unfair to tort victims and other involuntary creditors.
3. **Improper purpose:** If a corporation is formed solely for an illegal, fraudulent, or improper purpose, then that company will be a mere cloak or sham.
4. **Thin capitalization:** Ownership of all or almost all of the shares of a corporation by one individual, coupled with inadequate capitalization, may provide sufficient grounds for disregarding the corporate entity.
5. **Representations of unlimited liability:** If a firm represented that its liability is unlimited, a subsequent assertion of limited liability would constitute fraud, and the veil may be lifted.
6. **Lack of respect for the corporate form:** lack of proper corporation authorization for transaction and the use of shareholder funds to pay corporate obligations has been cited in some cases as supporting the disregard of corporate personality. Some courts have found such grounds insufficient to lift the corporate veil.



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