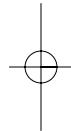


INCORPORATION AND BUSINESS GUIDE FOR ONTARIO

M. Stephen Georgas, LLB

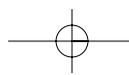


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- install the CD-ROM on your PC and check for updates to ensure you have the most current information, or
- visit <http://www.self-counsel.com/updates/inc/onincorp/2008upd.htm>.

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PREFACE

The purpose of this book is to provide sufficient information of a legal and practical nature to assist you in understanding incorporation procedures and to enable you to incorporate your own corporation.

By following the procedures set out in this book, you can save a substantial amount in legal fees for incorporating a corporation.

The book applies to a corporation that does not offer its securities to the public — in other words, the “private corporation.”

By explaining each step of an actual incorporation, the book will not only enable you to incorporate your own corporation, but will also provide information to help you maintain your corporate status. Once your corporation is incorporated, you must attend to various matters on a continual basis to preserve that status.

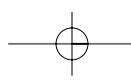
If questions of a complicated nature arise, such as tax, estate planning, shareholders’ agreements, or basic structural

corporate changes, you should seek competent legal and accounting advice.

In any case, it is recommended that competent professional help be sought as your business grows and with it your need for legal, accounting, financial, and other advice. This book is not meant to circumvent or to derogate from the value of professional help. It is meant as an aid to people who desire to incorporate and who simply want to become acquainted with the legal and practical implications of incorporation.

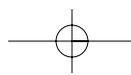
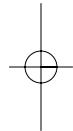
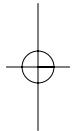
The incorporation procedures set out in the book apply only to “profit-making” businesses, not clubs, social corporations, co-operatives, credit unions, or the like.

The act governing the incorporation of businesses is administered by the Ministry of Government and Consumer Services, Companies and Personal Property Security Branch (CPPSB), whose members have been most co-operative and helpful in providing valuable assistance.



ACKNOWLEDGEMENTS

I would like to express my gratitude to Paul Edmonds and Gerry Courage, lawyers with the law firm Miller Thomson, LLP, for their assistance in editing Chapter 2, and to Catherine D'Aversa, Director of Corporate Services with Miller Thomson, LLP, for editing this edition of the *Guide*.



1

INTRODUCTION TO THE INCORPORATED BUSINESS

Note: The CD-ROM included with this kit contains a link to applicable updates. Please install the CD-ROM on your PC and check for updates to ensure you have the most current information, or simply visit www.self-counsel.com/updates/inc/onincorp/upd.htm. Government updates can occur frequently and without notice, so installation of the CD-ROM is required.

You are probably already engaged in a small business or are thinking about starting one, either by yourself or with someone else. One of the first decisions to make is whether your business “vehicle” should be a proprietorship, a partnership (two or more persons), or a limited corporation.

a. METHODS OF CARRYING ON BUSINESS

Whether you run a small corner store or a large business like General Motors of Canada Limited, there are only three ways to carry on any business: through a corporation, as a sole proprietor, or as a partner in a business. There are also special entities such as organizations engaged in charitable or semi-charitable enterprises. These do not concern us here, and therefore will not be discussed.

1. The sole proprietorship and partnership

You are free to carry on business under practically any name you or your partners choose, subject to a possible “passing off” action for appropriating someone else’s name or a trademark infringement action. It is important to realize, however, that the law does not recognize the name of a proprietorship or partnership and, in any

legal action, the proprietor and/or partners must be named personally.

For example, Joe Citizen, carrying on business as XYZ GROCERY, if sued, would be named as “JOE CITIZEN carrying on business under the firm name and style of XYZ GROCERY.” The legal consequences of carrying on business in this fashion are explained later on.

The assets of a proprietorship belong to the individual parties and not to the business. Further, parties carrying on business either as a proprietorship or partnership are personally liable for any debts they incur through the business in favour of third-party creditors.

In addition, partners are fully liable for debts incurred by each other while acting in the course of business. That is, they are jointly and individually liable, regardless of the proportionate capital contribution of the individual parties.

It is important to realize that you may be deemed in partnership with someone even though you have made no formal declaration of such a partnership. (See Sample 1 for an example of a formal declaration.) This is because a partnership is created by the relationship of the parties and not by any formal act or documents signed by the parties.

According to the Business Names Act (Ontario), you can register a proprietorship or partnership with the Ministry of Government and Consumer Services (MGSC) by completing a registration form available from the Companies and Personal Property Security Branch (CPPSB) and paying \$80

SAMPLE 1 BUSINESS NAME REGISTRATION FORM

	Ministry of Government and Consumer Services	Ministère des Services gouvernementaux et des Services aux consommateurs	Registration Form 1 under the <i>Business Names Act</i> - <i>Sole Proprietorship / Partnership</i> Enregistrement Formule 1 en vertu de la <i>Loi sur les noms commerciaux</i> (<i>Entreprise personnelle / société en nom collectif</i>)
Print clearly in CAPITAL LETTERS / Écrivez clairement en LETTRES MAJUSCULES			
1. Registration Type / Type d'enregistrement		Page _____ of / de _____	
If B, C, or D enter "Business Identification Number" / En cas de B, C ou D, inscrivez le n° d'identification de l'entreprise.			
<input type="checkbox"/> A New / Nouvel		<input type="checkbox"/> B Renewal / Renouvellement	
<input type="checkbox"/> C Amendment / Modification		<input type="checkbox"/> D Cancellation / Révocation	
BIN Business Identification No. / NIE le n° d'identification de l'entreprise			
2. Business Name / Nom commercial		J & J I N D U S T R I E S	
3. Mailing Address of Registrant / L'Adresse postale de Registrant		1720 EGLINTON AVENUE EAST TORONTO ONTARIO ZIP 0G0 CANADA	
4. Address of principal place of business in Ontario (P.O. Box not acceptable) / Adresse de l'établissement principal en Ontario (Case postale non acceptée)			
<input type="checkbox"/> Same as above / comme ci-dessus			
Street No. / N° de rue Street Name / Nom de la rue		Suite No. / Bureau n° City / Town / Ville	
Province / Province ONTARIO		Country / Pays CANADA	
Postal Code / Code postal ZIP 0G0			
5. Give a brief description of the ACTIVITY being carried out under the business name. / Résumez brièvement le genre d'ACTIVITÉ exercée sous le nom commercial.			
A N T I Q U E B O T T L E S A L E S			
6. Type of Registrant / Type de personne enregistrée			
<input type="checkbox"/> A Sole proprietorship / Entreprise personnelle		<input checked="" type="checkbox"/> B Partnership / Société en nom collectif	
		<input type="checkbox"/> More than 10 Partners: records at business address / Plus de 10 associés : dossiers à l'adresse d'affaires	
7. Registrant Information / Renseignements sur la personne enregistrée			
Last Name / Nom de famille DOE		First Name / Prénom JOHN	
		Middle Initial / initiale 2 ^e prénom D	
Street No. / N° de rue 1200		Street Name / Nom de la rue ORIOLE PARKWAY	
		Suite No. / Bureau n° City / Town / Ville SUITE 101 TORONTO	
Province / Province ONTARIO		Country / Pays CANADA	
Postal Code / Code postal ZIP 0G0			
Additional Information. Only complete if the registrant is not an individual. See instructions 7/8 on the form. / Renseignements supplémentaires. À remplir uniquement si la personne enregistrée n'est pas un particulier. Voir les instructions 7 et 8 sur le formulaire.			
Ont. Corporation No. / (For Corporate Partners Only) N° matricule de la personne morale en Ontario Pour les personnes morales associées seulement			
7. Last Name / Nom de famille GREEN			
		First Name / Prénom JACK	
		Middle Initial / initiale 2 ^e prénom G	
Street No. / N° de rue 28		Street Name / Nom de la rue CAN ZONE DRIVE	
		Suite No. / Bureau n° City / Town / Ville SCARBOROUGH	
Province / Province ONTARIO		Country / Pays CANADA	
Postal Code / Code postal ZIP 0G0			
Additional Information. Only complete if the registrant is not an individual. See instructions 7/8 on the form. / Renseignements supplémentaires. À remplir uniquement si la personne enregistrée n'est pas un particulier. Voir les instructions 7 et 8 sur le formulaire.			
Ont. Corporation No. / (For Corporate Partners Only) N° matricule de la personne morale en Ontario Pour les personnes morales associées seulement			
9. Print name of person authorizing this registration / (either the sole proprietor, a partner or a person acting under a power of attorney) If the person is a corporation, complete additional information below only. / Indiquez en lettres majuscules le nom de la personne autorisant l'enregistrement / (propriétaire unique, associé, ou personne habilitée en vertu d'une procuration). (Si c'est une personne morale qui autorise l'enregistrement, compléter les renseignements supplémentaires ci-dessous).			
Last Name / Nom de famille DOE		First Name / Prénom JOHN	
		Middle Initial / initiale 2 ^e prénom D	
If person authorizing the registration is not an individual (eg. corporation, trust, syndicate), print name below and do not complete last, first and middle names above. / Si la personne qui autorise l'enregistrement n'est pas un individu (c'est-à-dire une personne morale, un trust ou syndicat) ne pas remplir le nom de famille, prénom et 2 ^e prénom.			
Additional Information / Renseignements supplémentaires		MINISTRY USE ONLY - RÉSERVÉ AU MINISTÈRE	
It is the responsibility of the applicant(s) to ensure the accuracy of the information submitted. It is an offence under section 10 of the <i>Business Names Act</i> to submit false or misleading information. / Il incombe aux demandeurs de veiller à l'exactitude des renseignements présentés. Le demandeur qui fait une déclaration fautive ou trompeuse commet une infraction en vertu de l'article 10 de la <i>Loi sur les noms commerciaux</i> .			
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for registrations done by mail. (Electronic filing is also available, for \$60. Go to www.mgs.gov.on.ca.)

There is no established definition of what constitutes a partnership, although the following questions are a guide.

- (a) Is there a sharing of net profits and losses?
- (b) Do any of the parties act as agents for the others?
- (c) Is there any property held in joint tenancy?
- (d) Is there any implication of partnership on your firm's letterhead or in its correspondence?
- (e) Is the nature of the work relationship that of a partnership?

2. The corporate entity and advantages to incorporating

Many people prefer to carry on business as a corporation because a corporation is a distinct legal entity, an artificial person quite different from the people who are its shareholders. When you incorporate, you actually create a new person in the eyes of the law. The assets and debts of a corporation belong to it — not to the individual shareholders. Because of this, there are four major advantages for people who incorporate their business.

- (a) There may be a greater source of capital available than in a partnership. Since the corporation is a "person," separate from its shareholders, people may invest money in it without accepting any further responsibility for conducting the company business, and without worrying about becoming liable for the debts of the "corporation."
- (b) Since the corporation is a separate "person," it does not expire when the shareholders die. Substantial estate planning benefits result from this aspect of incorporation.

- (c) The most advantageous and unique characteristic of a corporation is its limited liability, and this is why corporations are referred to as "limited companies." The words "Limited," "Limitée," "Ltd.," or "Ltée"; "Incorporated," "Incorporée," or "Inc.;" "Corporation" or "Corp." must appear in the names of all corporations.

This means that as a shareholder you are not liable for any act, default, obligation, or liability of the corporation, with certain exceptions. This is obviously an important advantage. However, There are certain practical considerations to make. The most important one being that, in many instances, creditors, particularly banks, will not extend credit to a small corporation without your personal guarantee as a shareholder. However, if you do not personally guarantee your corporation's loans, then your liability as a shareholder is limited.

The following examples illustrate the foregoing principles:

Example 1

John Doe and Jack Doe carry on business as a partnership known as J&J Industries.

J&J Industries incurs debts of \$25,200.

The assets of J&J Industries are \$10,200.

A creditor successfully petitions J&J Industries into bankruptcy or simply gets a judgment against J&J Industries.

All the assets of John Doe and Jack Doe, as individuals, including possibly their homes, cars, etc., may be executed against to repay the \$15,200 debt incurred by the partnership over and above its assets.

Example 2

John Doe and Jack Doe carry on business as a corporation known as J&J Industries Limited, with John Doe and Jack Doe the only shareholders, each having purchased one share at \$1 (although any number of shares can be purchased).

J&J Industries Limited incurs debts of \$250,000.

The assets of J&J Industries Limited are considered to have a market value of \$100,000.

A creditor successfully petitions J&J Industries Limited into bankruptcy.

The creditors can realize \$100,000 on the assets of the corporation but they have no rights against John and Jack as individuals, regardless of the value of personal assets that John and Jack may own outside the corporation. The creditors are creditors of the corporation, not of John and Jack.

In arranging credit with a financial institution, it may be advisable, if not necessary, to arrange for life insurance on the lives of the shareholders. Depending on how the policy is arranged, different income tax consequences may arise, so professional advice should be sought.

(d) The tax advantages of incorporating are so important that a whole chapter has been devoted to the subject (see Chapter 2).

To summarize, there are three main legal forms an organization can take. These forms and their individual characteristics are outlined briefly below for quick reference.

Proprietorship

- Unincorporated
- Owned by one person
- Creditors have a legal claim on both the investment in the business and the personal assets of the owner

Partnership

- Unincorporated
- Each partner has unlimited liability in a general partnership arrangement
- The acts of one partner in the course of the management of the business are binding on the other partners

- The partnership dissolves upon the death or withdrawal of any partner, or upon the acceptance of a new partner
- Creditors have a legal claim on both the investment in the business and the personal assets of the owners

Corporation

- Incorporated in most provinces by Memorandum of Association or Articles of Incorporation, or federally by Articles of Incorporation
- Exists as a separate legal entity
- Shareholders are not liable for any act, default, obligation, or liability of the corporation, with certain exceptions
- May possess tax advantages

3. Disadvantages to incorporating

First, operating through a corporation does entail extra paperwork. You have to maintain minutes of your meetings and written resolutions, and keep registers. You have to file two tax returns: one for your corporation and one for yourself. There may be additional government paperwork to do from time to time, which could be avoided by operating as a sole proprietor. Also, there is the cost of setting up and maintaining a minute book and records office (see Chapter 5).

Second, any active business income in excess of \$300,000 per year does not enjoy the small business tax incentive; income at this level attracts normal corporate tax rates. However, I assume that this situation applies to so few people that further comment is unnecessary.

Third, there is the cost and bother of doing the incorporating. By the time you are finished, you will have spent approximately \$500 (in disbursement costs) and a few hours of your time. Is it worth it? Only you can judge.

b. FINANCIAL STATEMENTS AND THEIR IMPORTANCE

Regardless of what the law says and no matter what legal form an organization may take, the preparation of meaningful financial statements is vital to any enterprise. This is because various people will have an interest in the financial affairs of the organization, namely, owners, managers, creditors, Canada Revenue Agency (CRA), and prospective buyers.

To illustrate, assume that you are a bank manager and that J&J Industries Limited, a medium-sized corporation in the business of manufacturing, approaches you for a \$100,000 loan. The principal explains that the funds are necessary for plant expansion. As a prospective creditor you would be interested in two things: the ability of J&J Industries Limited to pay the regular instalments of principal and interest on the loan, and the amount you — the bank — would recover if the corporation could not meet its obligation. To satisfy your curiosity, you would have to examine the financial statements of the corporation. The annual income would be shown on the profit and loss statement. This figure, if compared with the income from prior periods, would indicate to you the rate of economic growth of the enterprise.

In addition, you would be able to determine whether or not enough total revenue is generated to repay the proposed loan. The balance sheet of the corporation would indicate any other long-term debt for which the corporation is liable. Furthermore, you would be able to determine which assets (inventories, accounts receivable, etc.) are available as security for the proposed loan.

The corporation's ability to pay its current obligations is another important indicator of the economic health of the enterprise. This ability to pay present debts when due can also be determined from the balance sheet. This indicator is expressed as a ratio (called the "current ratio") and is calculated by dividing the total of the current assets by the total current liabilities. This is illustrated with the very simple example in Sample 2.

Current assets exceed current liabilities in the ratio of 2:1. In other words, the working capital position of the corporation in this case is healthy.

In summary, you would obtain much of the information vital to your decision regarding the loan would be obtained by looking at the financial statements of J&J Industries Limited.

SAMPLE 2 BALANCE SHEET

J&J INDUSTRIES LIMITED			
March 31, 20--			
Current Assets		Current Liabilities	
Cash	\$ 20,000	Trade payables	\$100,000
Accounts receivable	290,000	Wages payable	10,000
Inventories	90,000	Current portion of long term debt	90,000
TOTAL	<u>\$400,000</u>	TOTAL	<u>\$200,000</u>

This illustration shows how financial statements can be useful to potential creditors. Furthermore, financial statements are useful to anyone who has an interest (monetary or otherwise) in an enterprise. As an analogy: just as certain medical implements are the tools by which a doctor can get some indication of physical health, so financial statements are the tools by which interested parties can measure the economic health of an organization.

Below is a breakdown of the three major financial statements: the balance sheet, the profit and loss statement, and the statement of retained earnings. They are discussed here to enable you to get some idea of the function and contents of financial statements.

1. Balance sheet

The balance sheet is a position statement, not a historical record, and shows what the business owns and owes at a given date. There are three sections to a balance sheet: assets, liabilities, and owner's equity.

(a) Assets

Current assets are those that will be used up within one year of the current balance sheet date. Normal valuation of such assets is at original cost or market value, whichever is lower.

Fixed assets are those that will provide benefits to the organization over a longer period than the one year from the current balance sheet date. Valuation is generally at original cost minus accumulated depreciation. The amount of depreciation is based on the length of the useful life of the asset and the original cost of the asset.

To illustrate:

Building: original cost \$20,000

Useful life: 10 years

Portion of asset cost that expires in each period:

$$\frac{\$20,000}{10} = \$2,000$$

This type of depreciation is normally calculated on a reducing balance basis, but for illustrative purposes, I have used the straight line method. The sum of \$2,000 is charged to the profit and loss statement in each period and is accumulated on the balance sheet as a reduction of the original cost of the asset. Thus, five years after the building was purchased, the balance sheet would show:

Building, at cost	\$20,000
Less accumulated depreciation (5 x \$2 000)	\$10,000
Book value of building	<u>\$10,000</u>

Because the asset may be sold for more than the original cost, the book value does not necessarily indicate the amount the equity-holders should receive for their ownership of the building. (**Note:** "Equity-holders" in a corporation are shareholders.)

(b) Liabilities and owner's equity

Liabilities are those things that are owed by the company to others, both on a short-term and a long-term basis, and include things such as accounts payable, bank loans, and unpaid taxes.

Owner's equity is determined by subtracting liabilities from total assets and it represents the value of the owner's shareholding for accounting purposes. This value may very well be different from the fair market value of the owner's shareholding because fair market value can only be determined from what an arm's length purchaser would be prepared to pay for the shareholdings, and not necessarily what the shareholdings are valued at for accounting purposes.

2. Profit and loss statement

This statement indicates the profit or loss by subtracting the total expenses of a period

from the total revenue for that period. There are two ways of determining when revenue is earned and when expenses are incurred. They are —

- (a) Cash basis — No revenue is recognized until cash is received. No expenses are recognized until cash is paid out.
- (b) Accrual basis — Revenue is recognized as soon as it is earned. Expenses are recognized as soon as they are incurred. The date cash is received or paid out is irrelevant.

3. Statement of retained earnings

The statement of retained earnings shows accumulated retained earnings from year to year. Added to the opening balance of retained earnings for the year is the current year's net profit (after income tax). From that sum, dividends declared and paid are subtracted to arrive at a closing balance for the current year.

The closing balance is summarized on the balance sheet in Sample 3 as the entry Retained Earnings and Partners' Equity.

The closing balance for the current year becomes the opening balance for the following year.

c. WHERE TO INCORPORATE

Since a corporation is an artificial person, it must be created by someone. A corporation may be incorporated or "born" by a certificate of incorporation granted under either the Canada Business Corporations Act or the Business Corporations Act (Ontario).

The advantage of incorporating federally is that the corporation has the capacity of a natural person and protection of its corporate name on a nationwide basis. A provincially incorporated corporation has the capacity of a natural person only in the province of incorporation (although there are provisions for registration in other provinces).

For most "non-public" (i.e., small, private, family-owned and operated corporations), it is much more convenient to incorporate a provincial corporation. This book deals with Ontario corporations only.

d. PUBLIC VERSUS PRIVATE CORPORATIONS

For purposes of Ontario corporation law, corporations can be of three types: listed corporations, non-listed offering corporations, or closely held (private) non-offering corporations.

1. Listed corporations

Under this category are included most of the well-known, large public corporations that have stock that is actively traded on one or more recognized stock exchanges. This book does not discuss this type of organization.

2. Non-listed offering corporations

Under this category are all corporations with shares that are "publicly" held, but for one reason or another are not listed and traded on a recognized stock exchange. The most common example is the over-the-counter stock.

This book does not cover this type of organization because such corporations are "public" as far as the Ontario Securities Commission is concerned, and as such, are required to comply with the rules and regulations of the Ontario Securities Commission regarding issuing of prospectuses and other items.

3. Closely held (private) corporations

Obviously, not all corporations are incorporated for the purpose of selling shares and raising large amounts of capital. The general advantages of incorporation are explained earlier in this chapter. A different type of corporation was created by both provincial and federal legislation to give

SAMPLE 3
BALANCE SHEET FOR UNINCORPORATED BUSINESS

ASSETS			
Current Assets			
Cash on hand and in bank		\$720.12	
Accounts receivable less allowance for doubtful accounts		\$657.72	
Merchandise inventory valued at the lower of original cost or market		\$3,212.63	
Prepaid expenses		\$157.55	
Total current assets			\$ 4,748.02
Fixed Asset — At Cost			
Land		\$2,320.00	
Building	\$5,767.16		
Less: accumulated depreciation	<u>\$1 727.92</u>	\$4,039.24	
Store fixtures	\$3,726.12		
Less: accumulated depreciation	<u>\$982.36</u>	\$2,743.76	
Delivery truck	\$2,760.20		
Less: accumulated depreciation	<u>\$513.60</u>	\$2,246.60	
			<u>\$11,349.60</u>
			<u>\$16,097.62</u>
LIABILITIES & PARTNERS' EQUITY			
Current Liabilities			
Trade Accounts payable		\$2,772.18	
Accrued wage		\$75.20	
Employees' income tax payable		\$60.16	
Accrued real estate taxes		<u>\$220.00</u>	
Total current liabilities			\$ 3,127.54
Retained Earnings and Partners' Equity*			
Jones's share	\$6,484.84		
Smith's share	<u>\$6,484.84</u>		
			<u>\$12,969.68</u>
			<u>\$16,097.22</u>
*If the company was incorporated, this would read as follows:			
CAPITAL STOCKS			
Common stock, no par value, maximum selling price \$1			
Authorized — 10,000 shares			
Issued and fully paid for:			
Jones — 50 shares at \$0.01 = \$0.50			
Smith — 50 shares at \$0.01 = \$0.50			
Retained earnings \$12,969.68			
You will note that Jones and Smith still have equity of a total of \$12,969.68.			

small businesses the advantages of incorporation.

Private corporations can be thought of as “incorporated partnerships” rather than as corporations as we normally view them because they usually consist of one, two, or three people who are close personal friends, business associates, or family members.

Another important distinction to keep in mind is that in public corporations the directors, officers, and shareholders are often separate individuals. However, in private corporations, each individual may hold two or three positions in the corporation. For example, it is not unusual for one person to be, at the same time, a shareholder, officer, and director.

The directors on the board of a public corporation are usually a group of businesspeople respected in the community who bring to the board a wide variety of business experience. Their function is to act as “watchdog” over the officers and to protect the shareholders’ interest.

Most officers of large public corporations are “hired professionals” and they are in charge of the day-to-day activities. In many instances they also wield the greatest influence on the overall operations of the corporation.

Usually the two or three top officers of the corporation are also members of the board of directors.

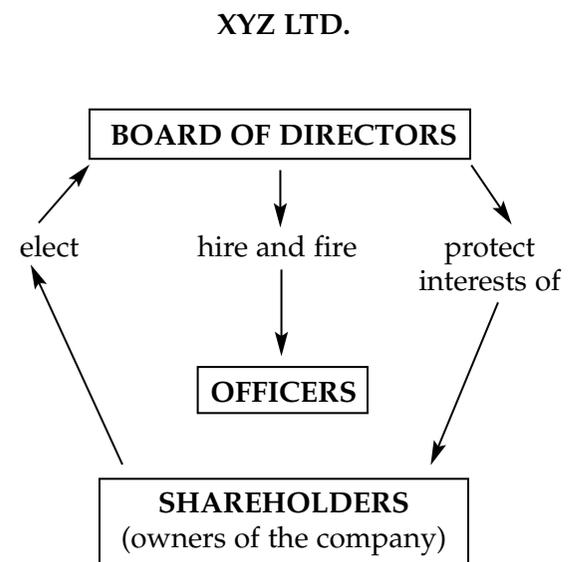
The last group in a public corporation, but certainly the largest in terms of numbers, is the shareholders. In public corporations this group is the “owner” of the corporation, which in turn owns the assets. Shares represent ownership. However, ownership of shares does not usually vest in the shareholder the right or power to run the corporation.

In theory, the final authority for a corporation’s operation rests with the shareholders. In the reality of public corporations, shareholders may choose not to exercise this right for many reasons.

Shareholders are often spread all over the country, so very few attend the annual meeting. Most shareholders want only a return on their investment (dividends) and an increase in value of their shares; they do not want to run a corporation. If the corporation does not perform satisfactorily, the shareholders may simply sell their shares rather than call the management or directors to task or replace them. Furthermore, many shareholders lack the competence and business experience necessary to run the business properly so they hesitate to question the activities of managing officers or directors.

Finally, the usual wide dispersal of shareholders means that it would take a great deal of time, money, and effort for a group of reform-minded individuals to obtain enough support to seriously challenge the management or directors of the corporation.

If you were to visualize the hierarchy of a public corporation, it would look like this:



All corporations must have directors, officers, and shareholders. One distinction between public and private corporations is that in public corporations these positions are generally occupied by different persons. A vice-president in a public corporation may not necessarily be on the board of directors and will generally not own enough shares of the corporation to affect corporate policy from a shareholder's position. His or her effect on the operations of the corporation will derive solely from his or her position as an officer of the corporation.

In a private corporation, these positions are usually occupied by the same people. For example, if you have a "family" corporation in which the husband has 50 percent of the shares, the wife 25 percent, and a son the other 25 percent, it is likely that these people will be the sole directors.

You need at least one director and the director(s) may appoint officers and specify their duties. Be careful not to confuse these positions, even though the people occupying them are the same. In a private corporation, you are often wearing more than one hat at the same time.

To illustrate, in the day-to-day activities of your small business, you are wearing the hat of an officer. If you decide, however, to branch out into a new area or to purchase or sell significant assets, you are wearing the hat of a director. (Important matters that will have considerable effect on the corporation are usually referred to the board of directors.) When you attend and vote at the annual meeting, or buy or sell shares, you are acting as a shareholder. The shareholder always has the final say on any serious issue because shareholdings represent ownership of the corporation.

You will find instances in which "partners" in a business, on a day-to-day level, are not 50/50 owners of a corporation on a shareholding basis. This is one of the great dangers of incorporating a small business.

The minority shareholder (less than 50 percent) is usually in a precarious position in relation to the majority shareholder (more than 50 percent).

I suggest that if you are in an incorporated "partnership" with another person who is not related to you, that you prepare and execute a shareholders' agreement that lays out the rules for the everyday management of the corporation.

You might ask what will happen when there is a basic disagreement over some issue and a deadlock results. The answer is that either the assets are sold and the business is wound up or one party buys out the other. This reflects the basic nature of a private corporation, which is that of an incorporated "partnership."

We all know what happens when partners in a business have an irreconcilable difference. The same is true in a small corporation. But a 50/50 split of the shares does encourage co-operation. When this balance is altered it will affect the personal relationship of the "partners."

Remember, this book discusses only those corporations not offering securities to the public. The distinction between corporations that offer securities to the public and corporations that do not is important and must be kept in mind, particularly for growing organizations seeking alternative methods of raising capital financing.

e. ONE-PERSON CORPORATIONS

Both the Canada Business Corporations Act and the Business Corporations Act (Ontario) allow the formation of a one-person corporation. This means that one person may be the president, secretary, sole director, and sole shareholder.

The evolution of one-person corporations recognizes that many persons are in business solely for themselves. (This is the so-called incorporated proprietorship.)

The procedures for incorporation are essentially the same for the one-person corporation as for the two-or-more-person corporation, but from a practical standpoint, the one-person corporation generally approves corporate transactions by passing a director's resolution rather than by holding a meeting (see Chapter 5 for further details).

f. HOW MANY SHARES SHOULD YOU ISSUE?

After the new corporation is incorporated and organized, it will require financing in order to begin operations. Capital flows into a business in two ways:

- (a) By investing in shares (i.e., equity capital)
- (b) By lending money to the business in some form or other (i.e., shareholder loans, bonds, debentures)

There are some definite advantages to capitalizing a business through loans, as opposed to buying shares, especially a high-risk business such as a newly "incorporated partnership."

First, capital "loaned" to the corporation, as opposed to "invested" in the corporation, can be repaid at any time tax free. That is, a loan to the corporation repaid to a shareholder is not income to the shareholder.

On the other hand, money invested in shares usually can't be repaid without tax consequences.

Second, if the new corporation has financial difficulties, a shareholder loan will generally rank equally with the other creditors when dividing up the remainder of the assets, and ranks ahead of repayment to the shareholders for money invested in shares. Common shareholders rarely see any proceeds when a corporation goes bankrupt or goes out of business.

Third, by minimizing the number of shares, you keep the initial capital investment at a minimum.

There is simply no advantage in financing the corporation only by issuing shares. In most simple incorporation situations, there is no real need to immediately issue all of the shares that you incorporated with to shareholders. The unissued shares remain in the company treasury and belong to the corporation itself until it becomes necessary to issue them to new shareholders. Just visualize all unissued shares as sitting in a large pot labelled "Company treasury" until directors' minutes issuing them to new shareholders are drawn up and filed in the minute book.

If a corporation is incorporated with an unlimited number of shares and there are only two shareholders, then only one share needs to be issued to each of them. If they each have an equal number of the issued shares, their interests are the same as if they had each taken 5,000 of the corporation's shares.

If you look ahead in the book at the model set of Articles of Incorporation (see Sample 9 in Chapter 3), you will see that the sample corporation is capitalized with an unlimited number of shares. Out of this "pool," 10 shares have been issued to the incorporator, John Doe, for a price of \$10, which should be deposited into the corporation's bank account.

As an alternative to issuing only 10 shares, you may want to consider issuing 1,000 shares at 10 cents per share. This way, it will be easier to sell any of these shares to another person because each share will have a lower value than if only 10 shares were issued. Similarly, it will be easier for a newcomer to your corporation to subscribe for shares from the company treasury, since each share would have a lower value than if only 10 shares had been issued initially.

A final and most important reason for limiting the number of shares you issue, is that if your business is successful, you may wish to bring in other “partners” who want to invest in the business. At that time a valuation of the amount of “equity” you have in the business will have to be made by your accountant.

Equity is defined as assets minus liabilities and represents the net worth of the business. From the examples here you can see that it makes no difference how many total shares are issued as long as your position in relation to other shareholders is not altered. Also, by keeping most of the shares in the treasury, you will be flexible enough to meet new corporation developments.

Samples 4 and 5 are balance sheets for a corporation where the number of shares issued to shareholders is 10 and 10,000 respectively. I have purposely simplified matters by deducting shareholders’ contributions in each case, because this is like transferring money from one hand to the next in a small, non-public corporation. I have also deliberately ignored the “good will” or capitalization of earnings factor, which merely serves to place a multiple factor on the net earnings.

As you can see in Samples 4 and 5, John Doe’s business is worth the same on a net return basis.

Another common situation is where another shareholder is brought in. In such a case you have two alternatives to consider.

First, you may simply transfer a percentage of each of the existing shareholder’s holdings to the new “partner.” If the shares are sold for more than you paid for them you will have to think about the capital gains tax liability.

Another problem with this method is that you frequently end up with a fractional share situation which is always annoying to deal with.

For example, suppose John and Jack Doe each own 50 shares. Their cousin, Helen, becomes involved and all parties agree that she should be an equal shareholder. To do this, both Jack and John would have to transfer $16\frac{2}{3}$ shares to Helen and each party would be left with $33\frac{1}{3}$ shares, which is an awkward situation.

A better solution would be to issue 25 more shares each to John and Jack Doe and then transfer them to Helen. Again, capital gains tax would have to be considered if the shares are transferred at a higher price than they were issued for.

On the other hand, if the shares were issued at, say, \$5 per share and this amount was paid into the corporation and the shares were then transferred for the same amount, then no tax would be payable.

The other alternative is to issue additional shares directly from the treasury to Helen at the price agreed upon. In this case, no capital gains tax would be payable because the money simply flows into the capital account of the corporation.

Of course, there would also be no direct benefit to John and Jack bringing Helen in, other than her contribution to the work effort. In other words, the corporation would have additional funds with which to finance its activities, but Jack and John could not receive any financial benefit from Helen’s purchase without paying tax.

In most cases, it is simpler to issue additional shares, either by issuing them directly to the new shareholder, or by issuing them to the existing members first and then transferring them to the new partner, rather than get involved in complicated partial share arrangements.

To recap briefly, there is no particular advantage to issuing all the shares unless you are involved in a complicated share control problem, and there are several disadvantages to capitalizing through share

capital. Therefore, it is wise to issue a minimum to begin with — for example, 100 to 1,000 shares to each shareholder, depending on the number of persons involved.

I have already covered the advantages of financing the corporation through loans rather than equity. You lend the corporation capital by simply writing a cheque and making a note on the cheque and bank deposit slip that it is a shareholder's loan. You can further record the fact that it is a shareholder's loan by drawing up directors' minutes and a demand promissory note for its repayment. (See Chapter 5 on post-incorporation procedures.) Your accountant or bookkeeper can make the proper entries from your cheque stubs.

g. CLASSES OF SHARES

As most small private corporations have no need for different classes of shares, you may ignore this section unless you are curious. Generally speaking, shares can have various rights and restrictions attached to them. A *class* of shares can be any set of shares that has attached to it rights that may or may not be different from the rights attached to another set of shares.

For example, when you start your business, you should incorporate with and issue "common shares" to all of the incorporators, so that all the shareholders of the corporation have equal rights to vote and receive dividends. When your corporation becomes successful, you might wish to create a different class of shares which, when issued to shareholders, will give them the right to receive dividends before holders of any other class of shares, or which have cumulative dividend rights, or rights to be redeemed by the corporation. You might refer to the new class of shares as "preferred" shares in order to distinguish them from the other shares that you first issued from the treasury pool. Large public corporations usually have different classes of shares.

Remember, it is much easier to add rights and restrictions at a later date rather than attach them now and then have to buy them up or strip them. If you later wish to create classes of shares that have different rights attached to them, you should see a lawyer so you can carry out the alterations of your Articles correctly and design your capital structure properly to minimize taxes and maximize control.

SAMPLE 4
BALANCE SHEET
 (Where 10 shares are issued)

JOE DOE & ASSOCIATES LTD.			
ASSETS		LIABILITIES	
Cash	\$ 10	Note to the bank	\$ 2,000
Inventory	\$ 4,000	Shareholder loan	\$ 3,000
Building	<u>\$ 5,000</u>		
Total assets	\$ 9,010	Total liability	<u>\$ 5,000</u>
NET WORTH			
Capital stock authorized — unlimited shares			
Issued 10 shares at \$1.00 each			
		\$ 10	
		<u>\$ 4,000</u>	
		<u>\$ 9,010</u>	

Note: The corporation has earned \$4,000 to date. Each share is worth \$401 (total net worth divided by 10) but as \$1 of this amount is shareholders' money and it is really a matter of transferring it from one hand to the other, it really should not be included in determining the value of the corporation from the shareholder's point of view. Therefore, if the assets of the corporation were liquidated tomorrow it would be worth \$4,000 in *net return* to the shareholders.

SAMPLE 5
BALANCE SHEET
(Where 10,000 shares are issued)

JOE DOE & ASSOCIATES LTD.			
ASSETS		LIABILITIES	
Cash	\$ 40,000	Note to the bank	\$ 2,000
Inventory	\$ 4,000	Shareholder loan	\$ 3,000
Building	<u>\$ 5,000</u>		
Total assets	\$ 49,000	Total liability	<u>\$ 5,000</u>
NET WORTH			
		Capital stock authorized — unlimited shares	
		Issued 10 000 shares at \$4.00 each to John Doe	\$ 40,000
		Retail earnings	<u>\$ 4,000</u>
		Total liability and equity	<u><u>\$ 49,000</u></u>
Note: If the business is wound up, John Doe's shares are worth \$44,000 but \$40,000 of this is John Doe's own money. Therefore, the net return would again be \$4,000.			