Choosing A Business Structure - Understanding The Differences Between Corporations, Partnerships, And Joint Ventures

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The following is intended for general information only, regarding some of the issues relating to businesses operating in Saskatchewan. We advise you to seek specific legal advice prior to making any of the arrangements outlined in this article, as the particular facts of each person's situation will vary, as will the advisability and effectiveness of any particular strategy.

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1. Corporations

Legal Nature

A corporation is a legal entity (or artificial person) which is created pursuant to specific legislation. In Saskatchewan, business corporations are created by registering the required incorporation documents with the provincial Corporations Branch, pursuant to The Business Corporations Act of Saskatchewan (the "SBCA"). Alternatively, a federal business corporation can be created by registering incorporation documents with the federal Corporations Branch, under the Canada Business Corporations Act. A federal corporation must then be registered with the Saskatchewan Corporations Branch, in order to carry on business in Saskatchewan.

Once the corporation is incorporated, subject to any limitations contained in its articles of incorporation and the SBCA, it has all of the rights of an individual. It can own its own properties, carry on business in its own name, and enter into contracts. It exists separate and apart from the persons who own the corporation (the shareholders).

Ownership and Participation

Investors participate in the corporation by purchasing shares. The percentage of ownership which investors have in the corporation, and their right to participate in receiving a part of the assets and profit of the corporation, is controlled by the number and type of shares which are issued to them. Shares are generally divided into different classes, with each class having specific features (that is,
rights and obligations). The most common features attached to the different classes of shares are as follows:

- **Voting rights.** Do the class of shares which the investor will be buying have a right to vote? Those shares having the voting rights will be allowed to vote at shareholders meetings, and will control (most importantly), the election of directors. The right to elect directors means that the voting shareholders will be able to change the board of directors if they do not agree with the management of the corporation.

- **Dividend rights.** What rights do the holders of a particular class of shares have to receive dividends? A dividend amounts to a payment made by the corporation to its shareholders from excess profits of the corporation. Some classes of shares may provide that the dividends are entirely discretionary, which means that a dividend will only be received by the shareholders as and when the directors decide to declare such dividend. Other classes may provide for a fixed dividend, where the shareholder is entitled to receive a fixed amount per share per year (assuming there is sufficient profit in the corporation.) The type of dividend a shareholder is entitled to receive, and when he or she is entitled to receive that dividend, depends upon the specific dividend rights which are attached to the particular class of shares.

- **Participation rights.** What rights do the holders have to participate in a division of the assets of the corporation if the corporation is wound up or dissolved? In some cases the holder will be entitled to receive a pro rata share of the assets based upon the number of shares he or she owns; in other cases, the holder may only be entitled to receive back the original issue price (or purchase price) of the shares.

Shareholders who have the right to participate pro rata are said to be "equity" shareholders, or to be participating in the growth (or loss) of the corporation. For example, two investors start a new corporation, and invest $50,000 each by purchasing equity or growth shares (often referred to as "common" shares.) They each own 100 common shares. No other common shares are issued by the corporation. Ten years later, the corporation is worth $1 million. The two original investors would be entitled to receive that $1 million of value if the corporation was wound up. They have participated in the growth of the corporation, because the initial $50,000 investment by each of them is now worth $500,000 to each of them. Alternatively, if the corporation is worth less than the original investment, these same two shareholders will have lost a corresponding amount of their investment.

Shareholders who have only a fixed right to participate in the assets of the corporation are often called "preferred" shareholders. They will only receive back a fixed amount should the corporation be wound up, or should they sell their shares back to the corporation. The share structure will usually provide that the preferred shareholders will receive this fixed amount on a winding up before the common shareholders receive any payment on their shares (that is, they have a "preferred" right of payment.)
- **Redemption or Retraction Rights.** A redemption right is the right of the corporation to buy back the shares. This potentially gives the corporation the right to force the shareholder out of the corporation. A right of retraction is the right of the shareholder to demand that the corporation buy back his or her shares. This then gives the shareholder the right (subject to certain liquidity tests) to compel the corporation to buy the shareholder out, should the shareholder wish to reduce his or her shareholdings, or exit the corporation.

Not all shares will have a right or redemption or retraction. Generally common shares have no such rights attached, while preferred shares will often have either a right of retraction or redemption, or both.

There are also less common features which may be incorporated into a share class, such as a right of conversion, which allows the shareholder to convert his or her shares of one class into shares of another class.

Investors who are incorporating their own corporation can create a share structure which mixes and matches these different rights in whatever way will facilitate the operation of the corporation, meet taxation objectives, and make an appealing investment to others. While certain basic share structures are very common, there are many variations which can be created in order to meet the incorporators' or investors' objectives.

**Liability**

A corporation has what is known as "limited liability". This means that if the corporation owes money to anyone (whether suppliers, banks, or someone who has sued the corporation and obtained a judgment), only the assets of the corporation can be seized or otherwise used by those creditors to pay the debts. The shareholders are not liable to pay the debts (unless they have given a guarantee for those debts.) In other words, only the assets of the corporation are at risk, and the assets of the shareholders are not at risk for the debts of or judgments against the corporation. If the corporation encounters financial difficulties, it will not directly affect the personal asset base of the shareholders.

The concept of limited liability has, over time, been somewhat eroded. Shareholders are often asked by financial institutions to give at least a limited guarantee of the corporation's debts. Further, a number of statutes make the directors and officers of the corporation personally liable for obligations such as payroll deductions, provincial sales tax, and wages.

**Management**

The business and affairs of the corporation is managed by the board of directors. The shareholders elect the directors of the corporation. Once elected, the directors have full authority to manage the corporation and are not obligated to consult with or take directions from the shareholders except with respect to certain matters and fundamental changes as set out in the SBCA.
If the shareholders do not agree with the manner in which the directors are managing the corporation, they may elect new directors. Alternatively, the shareholders can restrict the powers of the directors by entering into a unanimous shareholder agreement.

The board of directors, once elected, will appoint the officers of the corporation (such as President, Vice President, Secretary and Treasurer.) These officers may be delegated the authority to handle the day-to-day business of the corporation.

**Taxation**

Corporations are subject to income tax at one or more flat rates. A Canadian-controlled private corporation carrying on business in Saskatchewan is subject to corporate income tax of approximately 21% on its first $200,000 per year of active business income (which includes farm income). The $200,000 annual limit must be allocated amongst all associated corporations. Active business income in excess of the $200,000 annual limit is generally subject to corporate income tax at a rate of approximately 46%.

Dividends paid by a corporation to its shareholders are not deductible in calculating the corporation's taxable income. Shareholders pay tax on dividends at a lower rate than on business income because they are eligible for a dividend tax credit.

**2. General Partnership**

**Legal Nature**

A regular, or general partnership consists of two or more people (or corporations) who have agreed to carry on all of their trade or business for the joint benefit and profit of the parties to the partnership (the partners). The business carried on by the partnership is generally the sole or primary business or trade of the individual participants.

A partnership amounts to a contract or agreement between the parties that they will share the profit and loss of the business. The contract can be either verbal or in writing. The courts may also imply a partnership from the actions of the parties (that is, the way in which they share the profit and loss of the business.)

A partnership is not, in and of itself, a separate legal entity. All of the partners collectively own the partnership assets, carry on business, and enter into contracts. A partnership does not have a legal existence separate and apart from its partners.

**Ownership and Participation**

The rights of individual partners, and the obligations of individual partners to each other, depends entirely upon the agreement which exists between the partners. If there is no agreement, then the rights and obligations of a partner are determined by The Partnership Act.
Typically, a partner will make an initial investment of capital, either in cash or by the contribution of assets. In exchange, the partner will be given a certain percentage of ownership in the partnership. This percentage then governs the partner's share in the profit and loss of the partnership business, and his or her entitlement to share in the partnership assets in the event the partnership is ever wound up. For example, if a partner has a 25% partnership interest, he or she will usually be allocated 25% of the partnership profit or loss, will be responsible to his or her partners for 25% of the partnership's debts, and will be considered as owning 25% of the partnership assets.

Although essentially a very simple structure, partnerships can become very complicated, depending upon the nature of the agreement existing between the parties. Because a partnership is created entirely by agreement, it has a great deal of flexibility in terms of setting out the rights and obligations of the partners. Once created, the structure of the partnership cannot usually be changed without the unanimous consent of all of the partners, since they will all be required to sign any document amending the original agreement.

**Liability**

The major drawback to partnerships is the unlimited liability which exists for the partners. All of the partners, in their individual capacities, are jointly and severally liable to the partnership creditors for the partnership debts. This means that:

- any creditor of the partnership can sue all or any one of the partners for the entire amount of the debt; and

- all of partner's assets, whether owned personally or by the partnership, are at risk and can be seized by the creditor to satisfy the debt.

In order to limit the risk involved in a partnership, individual partners will sometimes incorporate, so that the person's partnership interest is actually owned by a corporation (often called a "holding corporation"). In this way, only the corporation's assets are then at risk, as a partner of the partnership.

**Management**

The way in which a partnership is managed is governed by the partnership agreement. Often the day to day operations are delegated to one person (a "Managing Partner") or a committee (often called the "Executive Committee"). Major decisions are then usually made at a meeting of partners. The agreement may provide that some decisions require a majority vote, some require a higher percentage such as 2/3 of the votes, and some require unanimous consent. The partnership agreement may also provide that partners are either voting or non-voting partners.

**Taxation**
The income or loss for tax purposes of a business carried on by a partnership is calculated by the partnership but the partnership is not itself liable to pay income tax. Instead, the income or loss is allocated to the partners. Each partner includes his share of the partnership income or loss in calculating his taxable income and pays tax at ordinary rates on the resulting taxable income.

3. Limited Partnerships

Legal Nature

A limited partnership is a special form of partnership permitted by The Partnership Act. It is created by registering the forms required by Part II of The Partnership Act. There is usually also a limited partnership agreement, which sets out the specific rights of the different types of partners (that is, general partners and limited partners.) A limited partnership amounts to an attempt to combine many of the features of a partnership with the limited liability offered by a corporation. As with a general partnership, a limited partnership is not, in and of itself, a separate legal entity. It will own its assets, carry on business, and enter into contracts in the name(s) of its general partner(s).

Ownership and Participation

Individuals or corporations participate in a limited partnership by purchasing partnership interests, usually referred to as "units". Depending upon the structure of the limited partnership, they may purchase either general partnership units or limited partnership units. Many limited partnerships are structured such that there is only one general partner, and investors may only purchase limited partnership interests. Some limited partnerships are structured such that investors may purchase either or both general partnership and limited partnership units.

Subject to certain restrictions set out in the The Partnership Act, the general partner(s) have all of the rights and powers and are subject to all the restrictions and liabilities of a partner in partnership without limited partners. Limited partners have only those rights and obligations given to them under the Act.

The percentage interest of a general partner or a limited partner in the limited partnership will be determined by the number of partnership units owned by each partner in relation to the total number of partnership units which are issued. For example, if an investor purchases five limited partnership units, and a total of 1,000 partnership units are issued, then the investor will have a 5/1000th partnership interest, or a .5% partnership interest. Limited and general partners are then entitled to receive a share of profits or other compensation by way of income pro rata according to their partnership interests.

Subject to the certain liquidity and other tests, limited partners are entitled to have their contribution to the partnership (that is, the purchase price for their units) returned to them, but have no further right to share in the assets of the partnership. General partners will therefore participate in the equity or growth of the enterprise; limited partners will not.
The rights and obligations of the general partners and limited partners are generally contained in a detailed limited partnership agreement. The agreement will usually contain many of the features found in a general partnership agreement, modified with respect to the particular rights and obligations of limited partners.

**Liability**

Unless the limited partner takes part in the control of the business, a limited partner is not liable to the creditors of the corporation except in respect of the amount of money or other property he or she contributes or agrees to contribute to the limited partnership.

A general partner has unlimited liability (as discussed above in section, General Partnerships). For this reason, the general partner is usually a corporation. If there is more than one general partner, their liability will be joint and several.

**Management**

The business of the limited partnership will be managed by the general partner. If there is more than one general partner, then the limited partnership agreement will provide for the holding of meetings of the general partners, similar to those provisions found in a general partnership agreement.

**Taxation**

A limited partnership and the partners in the partnership calculate income taxes in the same manner as in the case of a general partnership. Certain special income tax rules, which apply if the limited partnership incurs a loss, negatively impact limited partners, however.

**4. Joint Ventures**

**Legal Nature**

The legal nature of a joint venture is not, as yet, all that clearly defined. A joint venture amounts to the agreement between two or more parties that they are going to carry out a specific joint project or undertaking together, and that while it is a common enterprise, it is not intended to be a general partnership, nor a corporation. Although it is not, technically speaking, a partnership, it has also been said to be "in the nature of a partnership."

A joint venture is not a separate legal entity. All of the joint venturers will have a joint property interest in the assets of the joint venture as specified in their agreement. The manner in which they carry on business and enter into contracts will be also be specified in their agreement; sometimes they will carry on business collectively, and sometimes they will delegate these functions to one of the joint venturers (who is often then referred to as the "Operator").

**Ownership and Participation**
A joint venture is created entirely by agreement. All of the rights and obligations of the parties, and the manner in which the joint venture will be managed, will be created by the agreement between the parties.

Typically, each joint venturer will make some form of contribution, which will then entitle it to a percentage interest in the joint venture (often referred to as a "participating interest"). This participating interest will entitle the joint venturer to a pro rata ownership interest in the assets of the joint venture, as a tenant-in-common (meaning that each joint venturer has a defined percentage share of ownership in the assets, rather than an undefined collective interest in the whole of the assets.)

In order to distinguish the joint venture from a partnership and thus prevent it from being taxed as such under the Canadian income tax rules, the participants should not share in any of the profits of the enterprise. Instead, they agree to contribute their pro rata share of expenses, and are entitled to remove or receive a pro rata share of the product of the enterprise. A good example of this form of joint venture is a mining operation on a specific mine site. Each mining corporation makes a contribution which entitles them to a percentage interest in the joint venture. They each then contribute on an ongoing basis their percentage of the operating expenses of the joint venture, and receive the same percentage amount of ore or minerals which are mined. Each then takes its share of the product, and sells it as part of its overall operation, or delegates the selling of the product to the Operator as its marketing agent.

Other joint ventures may provide for a sharing of profit, rather than a distribution of product. This kind of joint venture, however, is almost indistinguishable from a partnership (except that it relates to a single specific project or "adventure"), and will be taxed as such.

**Liability**

Most joint venture agreements will attempt to avoid joint liability, and will often provide that the rights, duties, obligations and liabilities of the joint venturers are separate and not joint. However, the courts have held that notwithstanding such clauses, where a business liability is incurred by the joint venture, the joint venturers are all jointly and severally liable. In respect of third party claims, therefore, joint venturers will have the same liability as partners in a partnership.

**Management**

The manner in which the joint venture will be managed will be determined by the joint venture agreement. Often the joint venturers will agree to delegate the day-to-day management of the joint venture to one of the participants, known as the "Operator". The Operator will often hold title to the joint venture assets, have exclusive possession of the property, and will be in control of the business of the joint venture. The agreement might also provide for a management committee which supervises and provides directions to the Operator, or periodic meetings of the joint venturers for the same purpose.
Taxation

Each joint venturer separately calculates his income from the business carried on by the joint venture. The joint venturer takes into account his pro rata share of each kind of joint venture income and expense and his pro rata share of each joint venture capital purchase and disposition.

5. Contacting a Lawyer on this Subject

For more information on this subject or specific legal advice, contact Melvin Gerspacher at (306) 933-1324 or Chris Donald at (306) 933-1366.