4. CANADIAN BUSINESS ORGANIZATIONS

4.1 Overview

Canadian corporate/commercial law permits non-resident investors to utilize a wide variety of domestic or foreign business entities. Such entities are governed by a number of statutes including the *Canada Business Corporations Act* (the "CBCA") federally, and various provincial statutes such as the *Business Corporations Act* (Ontario) and include sole proprietorships, general and limited partnerships, joint ventures, co-ownerships, corporations, unlimited liability corporations, special purpose corporations, divisions of foreign entities, trusts and other business arrangements which can be specifically designed for non-resident investors.

4.2 Sole Proprietorships

A sole proprietorship is a business owned by an individual who carries on business in her or his own name or in a business or trading name. A sole proprietor is personally liable for all the debts and obligations of the business and is personally entitled to all of the profits derived from it.

4.3 Partnerships

(1) Definition

A partnership is the relationship which exists between two or more persons carrying on business together with a view to profit. The existence of a partnership is a question of fact and one may be found to exist in law without either the intention or knowledge of the parties.

(2) General Partnerships

General partnerships are governed in Ontario by the *Partnerships Act* (Ontario) which sets out the rights and obligations of partners among themselves and in their dealings with third parties. Each partner is an agent of the partnership with the result that all actions taken by a partner are binding on the partnership, and all partners are individually and collectively liable for the debts and obligations of the partnership. Under the *Partnerships Act* (Ontario), a partnership is not a legal person distinct from the partners of whom it is composed. A partner cannot, for instance, be an employee of the partnership of which he or she is a member. A partnership may exist among separate firms or corporations or between a firm and an individual as well as among individuals.

In the absence of an agreement to the contrary, a partnership is dissolved by the death or insolvency of one of the partners, upon notice given by one partner of her or his intention to dissolve the partnership, if it becomes unlawful for the business of the firm to be carried on either generally or in partnership, or by court order upon application of a partner in certain defined situations where it would be contrary to public policy for him to be unable to terminate the partnership. Upon dissolution, the assets of the partnership are applied in a prescribed manner requiring all partnership debts to be paid before the remaining assets can be distributed to the former partners.

It is common practice and considered essential in partnership relationships for partners to enter into a comprehensive partnership agreement governing their respective rights and obligations. Such an agreement supersedes the provisions of the *Partnerships Act* (Ontario) and provides some degree of protection for the parties involved in the partnership but cannot affect the rights of third party arm's length creditors.

In 1998, the *Partnerships Act* (Ontario) was amended to permit limited liability partnerships in certain self-regulated professions, currently law and accounting. Under such an arrangement partners are not liable for the negligent acts of other partners but the assets of the partnership remain subject to these liabilities. While Ontario was the first province to initiate this change several others have followed suit, most recently Manitoba in 2003 and British Columbia in 2005.

(3) Limited Partnerships

Limited partnerships are statutory creations which exist in Ontario pursuant to, and are governed by, the *Limited Partnerships Act* (Ontario). A limited partnership must have at least one general partner as well as at least one limited partner. The business of a limited partnership must be conducted by the general partner and the limited partner must not take part in the business operations of the partnership, save for inquiries into the business from time to time and advising on its management. Partners may be individuals or any other legal entity or organization. In practice, the general partner is often a shell corporation with minimal assets incorporated for that purpose.

The business of the partnership is carried on by the general partner which is liable for all of the debts and obligations of the partnership. The limited partners remain passive and their liability is restricted to the amount of capital which they have contributed or agreed to contribute to the partnership. A limited partner's liability becomes unlimited if the limited partner does not remain passive.

In the absence of an agreement to the contrary, a limited partnership is dissolved upon the retirement, death or mental incapacity of a general partner, or the dissolution by a corporate general partner. Upon dissolution, the limited partnership's assets must be distributed in the manner prescribed by the *Limited Partnerships Act* (Ontario).

(4) Limited Liability Partnership

Limited liability Partnerships (LLPs) are also statutory creations but the concept of the LLP is wholly different from the Limited Partnership described above. LLPs are similar to general partnerships, however, the partners in an LLP are offered some degree of limited liability. LLPs are currently not recognized in every province, but in Ontario, The *Partnerships Act* (Ontario*)* permits certain professionals, such as lawyers and accountants, to practice in limited liability partnerships provided that the act governing the profession expressly permits an LLP and requires the partnership to maintain a minimum amount of liability insurance. An LLP must also register its name under the *Business Names Act*. Under the Ontario legislation, the partners of an LLP are not personally liable for the negligent acts of another partner, however, that is the only limit to their liability and otherwise all partners continue to be liable for general contractual claims and debts.

4.4 Joint Ventures

Joint ventures are common in the Canadian legal system. However, they have no separate legal status nor any statutory recognition, except to the extent that joint venture is defined in the *Investment Canada Act* as any association of two or more persons or entities other than a corporation, partnership or trust. Generally, a joint venture is the creation of the parties who enter into an agreement governing their respective rights and obligations. A joint venture can take the form of whatever type of business organization is best suited to the interests of the parties, resulting in a closely held corporation, a general or limited partnership of corporations or individuals or a corporation which carries on a business in which the co-venturers are shareholders. It is common in Canada for joint ventures to be structured as a closely held Canadian corporation or a corporate partnership.

Whenever a joint venture is contemplated, it is essential to clearly define the form of business organization intended and to settle the terms of an agreement among the participants before any business is transacted. Business persons sometimes incorrectly use the term "joint venture" and subsequently discover they have formed a "partnership" resulting in undesired unlimited liability. Usually, the use of a corporation to conduct the business activities of a joint venture minimizes its risks since the use of the corporate structure limits the liability of the participants.

Under certain circumstances American investors may, for tax reasons, require an unlimited liability corporation which, although not generally possible under most provincial corporations statues, can be established under the laws of the Provinces of Nova Scotia and Alberta.

4.5 Co-ownerships

A co-ownership exists where two or more persons own property jointly. It is distinct from a partnership as a co-ownership does not necessarily carry on a business but rather passively owns property. In a co-ownership relationship, each co-owner is free to deal separately with his or her interest unless he or she has limited his or her ability to do so by contract with the other co-owners. A co-ownership agreement is advisable in all circumstances. A dispute resolution process is an important feature of such an agreement, as is a mechanism for the disposition of co-ownership interests. Additionally, the inclusion of a clause indicating that the co-owners do not intend to actively carry on business can avoid implications of a partnership.

Three principal advantages of a co-ownership structure are that co-owners are not agents for one another, each owns an undivided interest in the assets and each can claim separate tax treatment for his or her interest. When there are several investors in a commercial real estate project it is customary to establish a corporation incorporated for the purpose of holding legal title as a bare trustee or agent for the beneficial owners (the investors) each as to a designated undivided percentage interest in the property.

4.6 Corporations

(1) General Description

A corporation is a legal entity, separate and distinct from its shareholders. A corporation's assets and liabilities belong to it and not to its shareholders, and any distribution of net profits is accomplished by the declaration and payment of dividends to the shareholders who are also entitled to receive the net assets of the corporation upon dissolution. Such an entity is artificial and intangible, and existing only in contemplation of law. As such, it possesses only those powers and rights given to it by its charter or the applicable statute or the common law regarding corporations. Its activities must be recorded and documented in its corporate records and all necessary filings must be made to maintain its corporate existence.

In Canada, a corporation may be incorporated either federally or provincially. Federally incorporation corporations must obtain licenses to do business in all provinces which they carry on business. An Ontario corporation which carries on business in other provinces also requires an extra-provincial license except in the Province of Quebec. A corporation which is not an Ontario corporation but which wishes to carry on business or passively hold property in Ontario must apply for and obtain an extra-provincial licence.

The major advantage of incorporation is the limited liability of the shareholders with respect to the debts of the corporation. Additionally, the death or withdrawal of a shareholder does not have the effect of dissolving a corporation. However, in some circumstances it may be advantageous to expose shareholders to liability at which time an unlimited liability corporation or ULC, as described in Section 4.8, may be a useful tool. A corporation also has certain tax advantages more specifically described in Chapter 5. These factors help to make the corporation an attractive organizational structure for most non-resident investors.

(2) Capital Structure

The capital structure of a corporation governs the allocation of control of the corporation, participation in the profits and risk of loss during the existence of the corporation and the distribution of the assets of the corporation on dissolution. Generally, the capital structure of a corporation can be designed to fit the particular needs of each situation and an infinite number are available under either federal or provincial law upon satisfaction of certain minimum requirements. It is often through inventive share capital structuring that a variety of complex financing and other business objectives are achieved.

(3) Directors and Officers

The shareholders of a corporation are required to meet and vote on or sign shareholder resolutions annually to approve the financial statements of the corporation, elect directors if necessary, appoint auditors or accountants for the ensuing year and attend to any other matters of business which have

arisen. The business and affairs of a corporation are normally managed by its board of directors (or possibly a sole director or managing director for closely held private corporations) but a unanimous shareholder agreement may transfer such management duties to the shareholders. Usually the directors appoint officers to manage the day-to-day business and affairs of the corporation. A president, secretary and treasurer will ordinarily be appointed even if they are the same persons as the directors since standard corporate by-laws assign certain functions to such officers.

(4) Personal Liability of Directors and Officers

Under the CBCA and OBCA, as well as in many provincial corporate statutes, directors and officers of a corporation must act honestly and in good faith with a view to the best interests of the corporation and exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. Collectively, these duties are generally referred to as the directors' and officers' fiduciary duties.

Although generally directors, officers and shareholders do not incur personal liability for their actions, increasingly legislators have been keen on subjecting directors to personal liability as a means of regulating corporate conduct. Under the CBCA and OBCA directors of a corporation are jointly and severally liable to the employees of the corporation for all debts not exceeding six months' wages and under the OBCA, the directors are additionally liable to the employees for up to 12 months' of accrued vacation pay under the *Employment Standards Act*, or under any collective agreement made by the corporation. There are a myriad of federal and provincial statutes, including the *Income Tax Act*, which have subjected directors to personal liability in order to ensure that a corporation honours its monetary obligations to its employees, files its tax returns, pays its taxes, conforms to environmental legislation and that the corporation does not distribute assets or make guarantees which may render the corporation insolvent. Notwithstanding the expanding exposure of corporate directors and officers to liability, most statutory provisions also have specific due diligence and reliance defences where directors or officers are permitted to rely upon the representations of managers or other professionals.

(5) Residency Requirements for Directors

The recent amendments to the CBCA and the OBCA have reduced the residency requirement for most federally or provincially incorporated companies to 25% of the Board of Directors and in instances where the Board is composed of 3 or fewer individuals at least one must be a resident Canadian. Often, where a non-resident controlling shareholder is involved a board of three directors will be established, one of whom will be the non-resident controlling shareholder and the other two of whom will be trusted Canadian associates or appointees of the non-resident controlling shareholder. Subject to complying with the various duties imposed by law on directors, such appointees customarily act in accordance with the instructions of the non-resident shareholder. The nominee directors customarily require indemnification by the shareholder(s) and the corporation from any liability incurred in good faith and in many instances also require the provision of directors and officers liability insurance.

(6) Public and Private Corporations

A "public" corporation is one which offers or has offered its securities to the public. Such corporations may be widely or closely held but because a public corporation issues its shares to the public, it is subject to disclosure and filing requirements designed to protect the investor.

Generally, a "private" corporation is one in which the right to transfer shares is restricted, the number of shareholders other than employees is limited to 50, any invitation to the public to subscribe for its securities is prohibited and the securities have at no time been offered to the public. A private corporation does not attract the various filing, reporting and other requirements which are imposed on public corporations and the costs involved in operating a public corporation usually exceed those of a private corporation in similar circumstances. The securities legislation, both federal and provincial, is complex so the advice of experienced counsel is essential.

Both public and private corporations generally have all of the powers and capacities of a

natural person, unless restricted by their incorporating documents.

(7) Financial Statements

Financial statements must be prepared for each fiscal period of the corporation and presented to the shareholders before the annual meeting of shareholders. The statements must include a balance sheet, a statement of retained earnings, an income statement and a statement of changes in financial position. They must be prepared in accordance with the generally accepted accounting principles of Canada, as mandated by the Canadian Institute of Chartered Accountants, which require the production of more detailed statements than are necessary in some other countries. However for those CBCA corporations registered with the United States Securities and Exchange Commission, financial statements and audit reports may be prepared in accordance with the generally accepted accounting principles established by the Financial Accounting Standards Board of the United States. The financial statements must also be verified by an independent auditor unless the corporation is a private corporation and all of the shareholders consent to exemption from the audit requirements.

Many corporations controlled by non-resident investors utilize the foregoing exemption but nevertheless appoint an independent chartered accountant who supplies accountant's comments rather than an auditor's report. If this approach is sufficient to satisfy the needs of the shareholders it is often utilized in an effort to limit the cost of professional services.

Provincial/territorial securities agencies have responded to recent reforms in American corporate governance by introducing their own changes to reporting requirements. CEOs and CFOs of public corporations that are subject to security laws must now certify that their financial statements fairly represent their company's financial condition, the materials in their filing are accurate and complete, and must also design and maintain disclosure and internal controls over financial reporting.

(8) Unlimited Liability Corporations

Unlimited Liability Corporations (ULC's) are a relatively new phenomenon in Canada although the concept of unlimited companies originated in the English *Companies Act*, 1862. Until 2005, Nova Scotia was the only province where it was possible to incorporate a ULC. On May 17, 2005, Alberta passed the *Business Corporations Amendment Act*, 2005, in order to permit a company to be incorporated in Alberta as a ULC. On March 29, 2007, British Columbia became the third jurisdiction in Canada to offer the ULC after enacting an amendment to its *Business Corporations Act*.

A ULC, unlike a traditional limited liability corporation, is a corporation that exposes its shareholders to the debts and other obligations of the company to an unlimited degree upon the dissolution or liquidation of the corporation. The ULC is an attractive option for US companies who have operations in Canada since the U.S. Income Tax Regulations give a Canadian ULC the opportunity to elect not to be treated as a corporation for U.S. tax purposes but to be treated instead as a partnership or to be disregarded as an entity. This creates a tax advantage by permitting the flow-through of the profits and losses of the Canadian ULC to its U.S. shareholders.

There are some variations between the different jurisdictions offering ULCs. The BC ULC rules have been crafted to directly address some of the major shortcomings of the Alberta and Nova Scotia ULC regimes. Specifically, unlike in Alberta, there is no residency requirement for directors of a BC ULC which is in keeping with that province's elimination of any residency requirement for corporate directors. In addition, under the BC regime, shareholders are only liable if the ULC is dissolved or liquidated. It is expected that Ontario will also amend its corporate legislation to allow the incorporation of ULCs, however, as at the writing of this manual, no such changes have been implemented.

4.7 Trusts

(1) General Description

A "trust" is created when property is transferred to one or more persons (called "trustees") to be held by them for the benefit of certain other persons (called "beneficiaries"). The trust is a relationship between trustees and beneficiaries recognized by law and the duties of the trustees may be strictly enforced in the courts by the beneficiaries to ensure that the rights of the beneficiaries are adequately protected. The fiduciary obligations of trustees are strictly enforced and personal liability is imposed if a trustee acts in contravention of his or her legal obligations or in contravention of the provisions of the trust documents.

Trusts are primarily used to hold and administer assets for the benefit of future generations, to hold assets for persons who wish to remain anonymous and to register legal title to assets in the names of persons or institutions resident outside the investor's country of origin. In Ontario, trusts are often established by parents to acquire assets for the benefit of children under the age of majority (18 years in Ontario), because such persons cannot convey property recorded in their names. As indicated in Section 4.1 and elsewhere, trusts are frequently used by foreign investors.

(2) Business/Income Trusts

A business or income trust is a type of investment trust whereby a trust company, a banking corporation or an investment dealing company holds income producing assets. The market value of the entire portfolio is divided into trusts units which are marketed and traded in the same manner as shares of public companies. An investor who buys a trust unit becomes a beneficiary of the trust and based on the cash flow of the underlying business, receives the annual, monthly or quarterly distributions from the income of the trust. Trusts afford greater flexibility than the structure of a corporation and yet a similar relationship is created between a trustee and a beneficiary as that exists between a company and a shareholder.

The application of the trust principle in business has expanded tremendously over the years with the development of real estate investment trusts, income trusts and other such trusts as investment vehicles. The primary purpose of an investment trust is to enable the trustee(s) to pay out the annual income and net capital gains to the investors at no tax cost to the trust because distributed revenues are taxable only in the hands of the beneficiaries. As a result of the increasing number of corporations converting to income trusts, this tax advantage was effectively eliminated pursuant to recent amendments to the *Income Tax Act (Canada)*. Effective 2011, a distribution tax will be imposed on distributions from existing publicly-traded income trusts and limited partnerships. The new rules apply to any publicly-traded "income trust" (or publicly-traded partnership), other than one that only holds passive real estate investments. Additionally, the corporate income tax rate will also be reduced by one-half percentage point effective January 1, 2011, to eliminate the favourable tax treatment of income trusts.

4.8 Foreign Business Organizations

Non-resident corporations may carry on business in Canada without establishing a Canadian subsidiary corporation if an extra-provincial licence is obtained enabling the non-resident corporation to operate in the provinces in which it carries on business. Non-residents also have the following vehicles available to them to establish themselves within Canadian markets: franchising, licensing, distributorship or other arrangements which can be structured in a manner which enables the non-resident to retain some degree of control over the operation of the business in Canada.

Generally, the simplest approach for the non-resident corporation is to license its technology to a Canadian company subject to an extensive licensing agreement containing performance standards, rights to information and termination clauses which permit an easy exit if the performance by the licensee is inadequate or unacceptable. Ongoing monitoring and supervision is essential and the Canadian licensee must be thoroughly trained in the application and use of the technology. Our experience indicates that these arrangements frequently work well. However, when they fail the foreign company not only faces the cost and difficulty of terminating the existing agreement but must again go through the process of re-establishing itself in this country.

The appointment of a Canadian agent is also a relatively simple way for the non-resident firm to get its products and services into the Canadian market. Finding a suitable agent is always difficult and time consuming, the negotiation of the agency agreement requires considerable effort and the monitoring and supervision of the agent's activities poses an ongoing challenge and frequently results in conflict between the parties because one party or the other is dissatisfied with the performance of the other. Although not a business marriage or a partnership in law, a successful agency business arrangement requires a great deal of co-operation, education, patience and scrutiny.

Another possible business structure is to establish a Canadian branch of an existing business. However, doing so would expose the foreign company to unlimited liability, may create confusion with customers and suppliers, might require the undesirable disclosure of financial information and may complicate the non-resident corporation's tax position. While some foreign companies choose to adopt this approach, except in very unique circumstances we normally do not recommend it.

In any such endeavor, careful attention should be paid to the protection of intellectual property rights such as patents, trade-marks, copyrights, industrial designs, trade secrets and other confidential information.

4.9 Ontario's Filing Requirements

Pursuant to the *Business Names Act* (Ontario) sole proprietorships, partnerships and corporations operating in Ontario under a business name or style must register with the Ministry of Government Services. The registration must provide particulars of the parties involved and the nature of the business. Registrations are made available for public inspection and any amendments must be effected within a prescribed period. A renewal filing is required every five years.

A corporation is prohibited from carrying on business in Ontario or identifying itself to the public by a name other than its corporate name unless it first registers such name with the Ministry of Government Services and the full corporate name appears somewhere on its correspondence and documents. Similarly, sole proprietors cannot carry on business under a name other than their own name without first registering the name and partnerships must register the name of the partnership.

Limited partnerships formed in Ontario and limited partnerships formed elsewhere but which carry on business in Ontario must file a declaration under the *Limited Partnerships Act* (Ontario) with the Ministry of Government Services signed by all of the general partners stating the following: the firm name under which the business is to be conducted; the general nature of the business; the name and residence address (or address for service) of each of the general partners; and the partnership's principal place of business in Ontario. A limited partnership is not formed until the declaration is filed, any changes in the information contained in the declaration must be confirmed by the filing of a declaration of change and changes are not effective until such a declaration is filed. The information contained in all limited partnership declarations is available for inspection by the public but, the names of the limited partners are not required to be disclosed.

Fines will be imposed of up to $2,000 for individuals and $25,000 for corporations for failure to register a name or for registering false or misleading information. If a corporation fails to register a business name, the business is incapable of maintaining court proceedings without leave of the court.

4.10 Costs of Establishing a Business in Canada

A sole proprietorship or simple partnership can be established on payment of a nominal registration fee and only nominal legal costs need be incurred. A straightforward incorporation will involve legal costs of about $2,000 including fees payable to the appropriate government authorities. Annual costs are also involved in maintaining a corporation including minimum legal and accounting fees of about $5,000 and provincial and federal income taxes on any profits. Additional costs are, of course, incurred for each transaction or pre-incorporation matter in which professional advice is required.

The costs of establishing a partnership or co-ownership vary according to the complexity of the arrangements required. However, in all but the simplest of cases, a partnership or co-ownership agreement superseding the provisions of the *Partnerships Act* (Ontario) will be required. The legal costs involved in the preparation of such an agreement will likely be in the range of between $2,500.00 and $5,000.00 or possibly more if advice on taxes, regulatory regimes or governmental licencing are involved. Minimum annual legal fees will not necessarily be incurred in maintaining a partnership although if questions of interpretation of the partnership agreement arise, the legal costs may be substantial because each partner may require individual representation. Accounting fees for preparing financial statements and tax returns will be incurred each year and each member of the partnership may also be required to file Canadian tax returns or the partnership may be required to deduct withholding tax from all distributions of profits to the foreign partner and file the applicable returns. Annual accounting or audit fees incurred by a sole proprietorship or partnership may be comparable to those incurred by a corporation in similar circumstances although the provisions of the statutes requiring an audit for certain corporations do not apply to an unincorporated business.

It is virtually impossible to accurately estimate the cost of establishing a business in Canada. The prudent business person should therefore diligently investigate the costs involved in undertaking any such endeavour. Since the amounts of professional time required cannot be accurately estimated at the outset most professional advisers are unable to quote a fixed fee but will usually supply the client with an indication or guesstimate of the amount to be charged.

4.11 Conclusion

Non-resident investors have total freedom of choice among the many business organizational structures available in Canada. However, such investors should select the structure which is best suited to the nature of her or his business and business needs, the tax treatment of the organization chosen and the costs to be incurred in establishing such a business in Canada. Generally, incorporating a Canadian corporation is the recommended choice in most instances, but careful consideration by the investor or her or his advisor may disclose special circumstances which warrant another type of business organization being utilized in a specific situation.

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