INCORPORATION AND THE REASONS THEREFOR

By

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The corporation is clearly the most popular form of business and non-profit organization today. Whether it is a corner dairy shop, a consulting engineering firm, or a steel mill, the probability is that it will be incorporated before it opens for business. The same is true for the local curling club, drop-in centre, and charity. In terms of popularity, the proprietorship, the partnership, the trust, and other unincorporated associations are of no comparison. Traditionally, the very characteristics that distinguish the corporation from these other forms of organization have apparently all been regarded as advantages to be sought after. Included in the list are limited liability, perpetual existence, centralization of management, the free transferability of the ownership interest, and the ability to raise capital.[1] Why these characteristics should be considered as advantages in all organizations, however, requires closer scrutiny.

With a very few exceptions, publicly held organizations are incorporated. Limited liability is almost a must to raise capital. Witness the concern of the promoters of real estate investment trusts when the major stock exchanges suggested separate listings because of the slight possibility of unlimited liability.[2] Even the declarations of trust of such organizations require that all written contracts disclaim personal liability of the trust unit holders.[3] The only other popular form of organization is the limited partnership and even here there is partial limited liability, if not in fact total limited liability. Of equal importance is liquidity. The public demands the ability to buy and sell their interests at will. Free transferability of ownership is essential, whether it be the ability to deal with shares, as personal property, or the contractual right to dispose of trust or limited partnership interests. Promoters also want the ability to run the venture. Thus, the centralization of management of an organization that has perpetual existence completes the list of demands of both the public and the promoter. Again, in both the cases of the real estate investment trust and the limited partnership, management is centralized. In fact, except for two tax advantages, it is doubtful that in the case of public issues, any

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1 See Cary, *Corporations, Cases and Materials* (1968 Supp.) p. 14-17.

2 The *Toronto Globe and Mail*, November 28, 1972.

3 See *Supra* at n. 5.

other form of business organization would even be contemplated today. Any popularity for the real estate investment trust and the limited partnership appears to be a direct result of tax legislation. In the case of the real estate investment trust, it appears that the motivating factor is the flow through concept of income wherein the organization does not pay any tax when its income is passed on to the beneficial owners.[4] The limited partnership at one time possessed the right to not only avoid the payment of tax but also pass along to its owners, paper losses created by accelerated depreciation rates. But even in those situations where taxation favours some organization other than the corporation, planners have been known to give that other organization as many corporate characteristics as possible. Thus, because for tax purposes, partnership losses are deductible from other income, and corporate losses are not, in high risk ventures, the *Income Tax Act* favours the partnership. Oil companies have been known to use the partnership in drilling operations because the risk of a loss is substantial. However, they also limit their liability by creating a limited partnership (which interest happens to be freely transferable) with only one general partner (which happens to be a shell corporation which gives the organization a *de facto* limited liability and also a centralization of management). Only the problem of perpetual existence remains but as the only measuring life is the agreement and the life of the general partner, it is soon apparent that for most purposes, the organization has the appearance of perpetual life. In summary, insofar as public business organizations are concerned, the corporate form has very real advantages. This of course is of no surprise. After all, the evolution of the corporation was motivated by the desire to promote the expansion of business.

More surprising, however, is the degree to which the corporation has been adopted for use in the closely held business and the non-profit organization. Here limited liability is most often suspected as the motivating factor. However, in many cases, as a reason for corporation, it can often be superficial. Theoretically, the closely held company is in the same position as the publicly held company. In both cases the shareholder is legally only liable for any amounts unpaid on his shares (which are usually issued as fully paid). But in the case of the closely held company, financing institutions that advance money to closely held companies more often than not require the major shareholders to guarantee the advances. In the case of tort liability, most businesses insure for such possibility and thus, whether they are incorporated

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4 See *Income Tax Act*, S.C. 1970-71-72, c. 63, s. 104(6) as amended.

or not, the risk is passed on to someone else. While it is true that there remains the question of liability to the organization's trade creditors and those uninsurable tort claims, it is doubtful that this alone would weigh heavily in favour of the corporation over either a partnership or a proprietorship by itself. In fact, as for trade creditors, some unincorporated organizations have been known to contractually limit the liability of the beneficial owners. The prospectus of the TD Realty Investment Trust stated:

> The Declaration of Trust provides that any written instrument creating an obligation of the Trust shall contain a provision to the effect that such obligation is not binding upon any of the holders of the Trust Units personally. In the opinion of counsel, no personal liability will attach in Canada to the holders of Trust Units for contract claims under any written instrument containing such provision. There is a risk that a holder of a Trust Unit will be held personally liable for obligations of the Trust to the extent that claims are not satisfied by the Trust in respect of contract claims against the Trust when the liability is not disavowed as described above, and in respect of claims against the Trust that do not arise under contracts, including claims for taxes and possibly certain other statutory liabilities. It is considered that the risk of any liability of this nature arising is minimal in view of the large equity in the Trust and the nature of its activities being such that most of its potential obligations arise by contract where personal liability can be disavowed and that non-contractual potential obligations are largely insurable. However, upon payment of any such obligation the holder of a Trust Unit will be entitled to reimbursement from the available assets of the Trust. The Trust intends to carry insurance which the Trustees consider adequate to cover any foreseeable non-contractual liability to the extent such insurance is available at reasonable rates. The Trustees intend to conduct the operations of the Trust, with the advice of counsel, in such a way and in such jurisdictions as to avoid, as far as possible, any material risk of ultimate liability on the holders of Trust Units for claims against the Trust[5]

In summary, the advantage of limited liability of a corporation compared to a partnership or proprietorship may be more imaginary than real. In the case of the non-profit organization limited liability would appear not to be an issue. Whether the non-profit organization is incorporated or not, in both cases the members are not liable beyond their subscriptions.[6]

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5 *TD Realty Investment Trust Prospectus*, September 20, 1972, p. 13-14.

6 *Wise* v. *Perpetual Trustee* [1903] A.C. 139 (P.C.).

In the case of closely held business organizations, centralization of management appears to be more of a disadvantage than an advantage. The centralization of power in the board of directors often poses a serious threat to the position of the minority shareholder. The threat of complete loss of power is so great that resort is often had to complex shareholder agreements, buy-sell contracts and long term employment contracts. Their usefulness however, is often in doubt because the concept of centralized power has heretofor not been subject to control; any fetter on the discretion of the board of directors has been held repugnant to the express provisions of the companies acts.[7] It would seem then in such circumstances the partnership is much to be preferred. Subject to agreement, not only does each partner have an equal say in the management of the organization but he also has a right to the distribution of his share of the profits. Minority partners need not be as concerned as their counterparts in the corporation about the cream being siphoned off by the majority through executive compensation plans. In the case of the proprietorship, by definition, management is centralized. Incorporation of the one man business only serves to complicate his position for now he needs two additional bodies to complete the requirement of a board of directors in most jurisdictions. In theory, his power is diminished by two-thirds. In addition, he is now required to hold meetings or at least obtain their consent to act. As a practical matter, though, it is recognized that as he has the power to replace his nominees through the shareholders meeting, their potential power is much reduced and as a practical matter, most of these companies are truly managed by the company president and not the board of directors, despite the board's legal responsibility. However, the point is that centralization of management in the case of closely held companies is not necessarily an advantage and in many cases it can be a disadvantage. Unincorporated non-profit organizations are similar to corporations insofar as the centralization of management. Unlike partnerships, members of an unincorporated non-profit organization cannot bind the organization without actual or obstensible authority. Usually the organization is run by a management committee or trustees. In the search for the most appropriate organization, centralization of management is not an issue in the case of non-profit organizations.

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7 *Motherwell* v. *Schoof*, [1949] 4 D.L.R. 812 (Alta. Sup. Ct.); *Ringuet* v. *Bergeron*, [1960] S.C.R. 672.

Liquidity has always been a major concern in the case of the closely held business. In the case of the closely held corporation, the declaration that a share is personal estate does not solve the problem because there is a very limited market for closely held businesses, whether incorporated or not. Where it is a minority interest, the market is nearly non-existent. Sometimes a firm market is created through buy-sell agreements. In the case of a partnership, on the withdrawal of a partner, his interest must either be bought out or his share of the business be distributed to him through winding up, depending on the terms of the agreement. On the balance the closely held corporation would appear to have no liquidity advantages that are not to be found in a partnership or a proprietorship. In fact, where there is more than one beneficial owner, the partnership would appear to be preferable. As for non-profit organizations liquidity, of course, is not in issue.

The idea of perpetual existence probably plays the least role in the selection of the form of organization. After all, we are all mortal and from a practical point of view even the corporation is in jeopardy on the death of the majority shareholder. On the negative side, a shareholder *per se* has no right to his proportionate share of the profits. However, if the corporation were to be terminal he would eventually be entitled to an accounting on liquidation. In contrast, a partnership is terminal and the partners are each entitled to an accounting. Thus the combination of a lack of a right to an accounting of profits by virtue of the separation of ownership of the corporate assets and perpetual existence should tend to discourage incorporation. As for the sole proprietor, it is doubtful that perpetual existence plays much part in the decision whether or not to incorporate. But it may be that the Executor of the Estate of the owner of a business finds it easier to convince employees and customers that they now have a new president and shareholder and to continue on as usual rather than have to convince them of a new proprietor. Psychologically, the former seems easier to accept. As for non-profit organizations, the critical and most important factor is membership. As long as there are members, there is no reason why the organization will not continue. Incorporation has no magical solutions to dwindling membership.

If the supposed advantage of the ability of a corporation to raise capital is related to the concept of limited liability, then it is doubtful that as a general rule, it is easier for a closely held corporation to raise capital than for a partnership or proprietorship. If equity is being invested in the business from outside sources, they can always come in as limited partners (as is done in some public real estate syndications). There is one possible

exception to the general rule. Venture capital organizations are increasingly looking for small business investments with growth potential. In many instances, these organizations expect representation at least at the directorship level and this may demand more active participation in management than they could achieve in a limited partnership without jeopardizing their limited liability. As for non-profit organizations, the raising of capital usually takes the form of donations, the critical point being whether or not the organization is registered so that the donation is deductible for tax purposes. As for registration, incorporation is not really relevant. As for other non-profit organizations, these are mostly clubs of various sorts. Here the corporate form of organization sometimes serves a useful role. If the organization needs capital to build facilities, membership is often tied to a share ownership requirement. The organization has the needed capital, the member has his "investment" since when he leaves, presumably he can sell it to a prospective member.[8] There is nothing, however, to prevent the issuance of certificates by the unincorporated organization and imposing similar requirements.

The one remaining consideration is the question of taxation. In the past, there has been no question that there were substantial tax savings in many instances by the mere fact of incorporation. However, the recent amendments to the *Income Tax Act* in part attempted to eliminate the advantages. Technically, in the case of a small closely held corporation, a shareholder who receives dividends is taxed in the same amount as if he had received profits from a partnership through a system of gross up and credit of the tax paid by the corporation. The amount of the tax paid by the company is added to the dividend received and the taxpayer in turn is given credit for the payment. However, where the profits are not paid out in dividends but are retained by the company, there is a tax advantage through incorporation. The corporate rate of tax in 1972 was 50%. But taking into account the small business deduction, and ignoring for the moment abatement for and the levying of provincial corporate taxes, the rate is reduced to 25%. The small business deduction only applies to the first $50,000 of income and only while retained earnings do not exceed $400,000.

"The purpose of the small business deduction is to encourage and assist small business to reinvest profits in the business in order to aid expansion."[9] To prevent tax avoidance through incorpora-

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8 Section 77 of the *New Brunswick Companies Act*, R.S.N.B. 1952, c. 33 as amended permits the company to assist in the disposition of such shares.

9 Riehl, *Incorporation and Income Tax in Canada* 5th ed. (1972) 133.

tion merely to take advantage of the deduction, Parliament enacted what was referred to as the ineligible investment tax. Generally, the rule provided for the imposition of a refundable tax in the amount of the small business deduction where the earnings were not used in the *bona fide* expansion of the business in which the income was earned. The provisions imposing the ineligible investment tax were repealed retroactive to the commencement of the new tax system. The reason for the repeal was stated by the Minister of Finance in the following words:

> Under Part V of the Income Tax Act the benefit of the small business deduction was withdrawn to the extent that a corporation used its retained earnings for the purpose of making long term investments unrelated to its business activities. I believe that the policy which gave rise to the ineligible investment test was correct, but I have come to the conclusion that it is too complicated. I believe that these small corporations which enjoy the benefit of the lower rate of tax will in fact, use these tax savings to expand their business to improve their technology and to create more jobs for Canadians. For this reason, the ineligible investment test is not necessary. Accordingly, I propose that, effective January 1, 1972, the ineligible investment test be withdrawn.[10]

Apart from the apparent intent of the Minister, it appears that once again the corporate form of organization is a useful shelter for income, it being taxed at an effective rate of 25% which is reached at a taxable income of $15,000 if the amount were to be taxed at personal rates. Thus the *Income Tax Act* is a significant incentive to incorporate if the shareholders do not have an immediate personal need for the income.

The case of the non-profit organization is less clear. By section 149 of the *Income Tax Act* both the corporate and unincorporated forms of organization are exempt from tax and both are registerable for charitable contributions. However, despite the apparent neutrality of taxation and the very slight differences in other characteristics, the corporate form still has a surprising popularity. It is suspected that this popularity is a result of the certainty provided by the corporation that is not appreciated in other types of organizations. Both lawyers and the public feel comfortable in a corporate setting. There is a sense of being that exists if some public official has sanctioned the organization through the granting of the charter whereas after a constitution is approved it is merely filed away for future reference. There is also security to be found in the by laws adopted pursuant to the charter and statute as opposed to the constitution. Despite their often inapplicability to a non-profit organization, the standard by laws do give a sense of completeness to the rules of the organization.

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10 *Canada Tax Service*, p. 188-201.

A similar sense of security is felt with regard to the matter of holding property. Lawyers are accustomed to corporations buying and selling property. Despite readily available procedures of having trustees holding property,[11] if it is not frequently done in the commercial world, it takes on a sense of unusualness and following that, of doubt. Thus, the holding of property itself would appear to encourage incorporation for simply the matter of familiarity.

It also appears that the corporate popularity is in part attributed to a sense of prestige over other forms. All the giants of industry and many of the large foundations are incorporated. By incorporating, the local social club or the corner store is now one of them.

In summary, it is probably true the corporation is unquestionably the most popular form of business organization where public participation is involved. The characteristics of limited liability, perpetual existence, centralization of management, the free transferability of the ownership interest, and the ability to raise capital are all very clear advantages to be had by incorporation. In the case of the closely held corporation, special tax concessions, limited liability and certainty of the rules of operation are probably the most important considerations leading to incorporation with prestige a distant fourth. As for the non-profit organization, only the peripheral advantages relate in any way to them, certainty and prestige being in the forefront.

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11 See 19 *Encyclopedia of Forms and Precedents* (4th ed.) p. 1238-1240.