Felesky Flynn LLP
TAX COUNSEL

Insights Series: Tech Sector Income Tax Issues

This Felesky Flynn Insights Series focuses on tax issues relevant and specific to start-up businesses operating in the technology sector in Canada.

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STRUCTURING YOUR START-UP – TAX CONSIDERATIONS

The founder of a new technology start-up has many difficult issues to deal with and often tax is very low on the priority list. However, some careful planning at the outset can significantly alter the tax cost while the business is growing or on an eventual exit, and it may impact the start-up's access to investor capital or government funds, employee compensation and risk profile.

For any start-up tech business, a fundamental issue that should be addressed is what type of business vehicle will be used for the business. This becomes even more critical in circumstances where there are multiple founders involved or it is time for outside investors to supply capital. Often this issue comes down to whether the business should be carried on through a partnership or through a corporation. Whether business is carried on through a partnership or corporation will result in different tax consequences that should be carefully considered, as these tax consequences will impact current business operations and future business growth. The balance of this article will provide an overview of the differences between a sole proprietorship, a partnership, and a corporation as well as some relevant tax consequences in choosing one over the other.

Sole proprietorships or partnerships

A sole proprietorship is an unincorporated business carried on by a single individual. The proprietor has the ability to deduct losses against income from other sources and will pay personal income taxes on all net income generated. In contrast, a partnership is formed under the *Partnership Act* (Alberta) when two or more persons carry on business in common with a view to profit. A partnership will arise when these requirements are met, regardless of whether the parties have entered into a formal agreement to define their relationship. Note that the creation of an "informal" partnership is a potential trap for start-ups when more than one individual is involved but there is no documented legal agreement on their business structure. Unlike corporations, sole proprietorships and partnerships are not separate legal entities.

Though partnership income is calculated at the partnership level, a partnership is treated as a flow-through entity for tax purposes and partnership losses can be written off against a partner's income from other sources. This in many cases can be a significant tax advantage of implementing a partnership structure in the early stages of a business when losses may far exceed income generated. By deducting early stage losses against other sources of income the founders can, effectively, access government funds to subsidize their start-up costs.

While partnerships provide significant flexibility and can have many advantages, it is important to note that there are numerous complicated tax rules that may apply. For example, certain rules can limit the ability of certain investors to deduct losses. A limited partner may deduct its share of partnership losses only to the extent of the limited partner's "at-risk amount" in respect of the partnership interest, which, in general, is equal to the limited partner's cost of the partnership interest subject to certain adjustments. This prevents limited partners from deducting losses in excess of their investment in the partnership.

Other rules may create adverse consequences if a non-resident is a partner. A partnership will cease to be a "Canadian partnership" for tax purposes if any partner is a non-resident of Canada, regardless of whether the remaining partners are Canadian residents. As a result, persons making payments to the partnership may be required to withhold amounts under Part XIII of the *Income Tax Act* (Canada). However, this result can be avoided with certain structuring steps, such as having the non-resident partner invest in the partnership through a Canadian holding corporation.

Given the complicated tax issues that can arise, careful consideration of these rules will be important at each stage in the business cycle.

Corporations

A corporation may be formed under provincial, territorial or federal law with the ownership interests in the corporation defined by reference to its issued shares. In contrast to a partnership, a corporation is a separate legal entity. As such, a shareholder's liability for the debts and obligations of a corporation is generally limited to the shareholder's investment in the shares of the corporation. As corporations can issue different classes of shares with different voting rights, entitlements to dividends, and distributions on dissolution, incorporating can also increase access to capital and can facilitate employee compensation, enabling investors and employees to acquire ownership interests in the business without assuming unlimited personal liability. In addition, several corporations may be incorporated to further segregate and limit liability to particular business ventures and to protect particular assets.

There may be several tax benefits to incorporating, depending on the stage of the business. If the business is starting to generate some revenue, the fact that corporations are generally subject to lower tax rates than individuals may be beneficial. For example, a Canadian controlled private corporation ("**CCPC**") earning active business income in Alberta will have access to the small business deduction and will be subject to income tax of 11% on the first $500,000 of active business income earned and 23% on active business income earned in excess of this amount. This is in contrast to individuals, who are subject to a top marginal tax rate of 48% in Alberta. The lower corporate tax rates allow shareholders to defer a certain amount of income tax until funds are extracted from the corporation as dividends or salary. More importantly, in the early years, the tax savings can be reinvested in growing the business.

Operating through a corporation can also provide tax savings at the time of an exit or liquidity transaction. Individuals who dispose of shares that satisfy certain tests and qualify as qualified small business corporation shares may be able to avoid tax on the first $883,384 (in 2020) of capital gain by claiming the lifetime capital gains exemption. This has the potential to result in tax savings for Alberta residents of approximately $181,467.

CCPCs also have access to favourable investment tax credit incentives through the scientific research and experimental development ("**SR&ED**") tax incentive program. CCPCs qualify for a refundable federal investment tax credit of 35% of SR&ED expenditures of up to $3,000,000 annually. Expenditures in excess of this amount qualify for a refundable federal investment tax credit of 15%. Non-CCPCs and individuals are also eligible for investment tax credits of 15% on qualifying SR&ED expenditures. Stay tuned to Felesky Flynn updates for a more detailed summary of the potential benefits under the SR&ED regime.

Though incorporation offers several significant tax advantages, it can also limit a start-up's ability to deduct losses in the early stages of the business to offset an individual's income from other sources because losses of a corporation can only be deducted against income of a corporation. As a result, unless the corporation has other sources of income, the start-up losses cannot be immediately deducted, nor will corporate losses flow through to individual shareholders in the same manner as losses flow through to individual partners. Corporate losses can be carried forward to future years and should be available to shelter future income; however, there are rules that can limit the ability to use the losses. Where material loss balances have accumulated it is important to consider these issues each time there is a significant event in the corporation's life (*i.e.*, new shareholders).

Whether business should be carried on through a partnership or a corporation will depend on the particular needs of each business, and the desired business structure may change as the business grows. It is relatively easy to move from a partnership structure to a corporate structure in the future, as partnership assets may be transferred to a corporation on a tax-deferred basis. Conversely, while corporate assets may be transferred to a partnership on a tax-deferred basis, it will not be possible to eliminate an existing parent corporation in a tax-deferred manner.

In summary, there are real commercial differences between partnerships and corporations, and the decision to carry on business through a partnership or a corporation will have both commercial and tax implications. Incorporation may be advisable if you require immediate access to credits or other incentives. However, if incorporation is not necessary at this stage in your business cycle, and if your business is currently generating losses, a sole proprietorship or a partnership may be preferable as these business structures provide greater flexibility to utilize losses. Even if a sole proprietor or the partners of a partnership do not have sufficient income to use against losses generated in a taxation year, non-capital losses may be carried back 3 years or carried forward 20 years, while capital losses may be carried back 3 years and carried forward to any future taxation year. We recommend that start-ups engage tax counsel early on to determine what business structure best aligns with the current stage of the business while supporting and facilitating future business growth.

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