Doing Business in Canada

Business Entities

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III. Business Entities and Alternative Methods of Carrying on Business in Canada

A consideration of the different forms of business enterprises available under federal and provincial law will assist the investor in determining the most suitable arrangement for conducting business in Canada. Provincial law generally governs the forms of business organization although corporations may also be incorporated federally under the laws of Canada.

1. Corporations

A corporation with share capital is the most common form of business entity in Canada and enjoys advantages that make it the most practical form of business organization in most instances. Corporations may also be incorporated without share capital, generally for not-for-profit purposes. A corporation is a separate legal entity, distinct from its shareholders and management, that can hold property, carry on business and incur contractual and legal obligations.

1.1 What types of corporations are available in Canada?

1.1.1 Will the Canadian subsidiary be a private or public corporation?

Canadian legislation governing corporations distinguishes between non-offering corporations (commonly referred to as private or closely held corporations) and public offering corporations. Private corporations generally are subject to restrictions on the transfer of their shares, a maximum permitted number of shareholders, excluding certain classes of individuals such as employees, and prohibitions against the issue of securities to the public. Public corporations do not have these restrictions and have taken steps under applicable provincial securities laws and stock exchange rules to permit their securities to be offered to, and traded by, the public.

Because shareholders of private corporations often participate actively in the management of the corporation, they do not require the same statutory protections that are essential for shareholders of public corporations. Many rules that apply to public corporations with respect to directors, insider trading, proxy solicitation, filing of financial statements, appointment of auditors, take-over bids and public disclosure, including disclosure related to diversity of the board of directors and senior management, do not apply to private corporations. However, private corporations in British Columbia and those incorporated federally, are required to maintain a register of individuals with significant control over the corporation. All shareholders, whether of a private or public corporation, have substantial rights with respect to fundamental changes affecting the corporation, including, in some cases, dissent and appraisal rights and a very broad oppression remedy.

1.1.2 Should the subsidiary be incorporated federally or provincially?

Corporations wishing to carry on business in more than one province or in foreign countries may prefer to incorporate under federal law. This permits the corporation to use its corporate name in every province in Canada (with the use of the French form of its name also being required in Quebec). Also, federally incorporated corporations may be more widely recognized and accepted outside Canada, though there is no legal basis for this perception. Registration would be required to carry on business in any particular province in Canada.

When a corporation incorporates in a province, it must register and may be required to obtain an extra-provincial licence in any other province where it carries on business. Unlike a federal corporation, its corporate name may not be available for use in every other province or territory in Canada, in which case, it would be required to operate under an assumed name in that jurisdiction.

There may be additional factors affecting the decision of whether to incorporate federally or provincially. For example, differences in residency requirements for directors may be relevant in some cases. As well, U.S. investors may be interested in the possibility of incorporating an "unlimited liability company" (ULC) in British Columbia, Alberta or Nova Scotia to achieve certain U.S. tax objectives. A ULC is treated as a corporation for Canadian tax purposes but may be eligible for flow-through treatment for U.S. tax purposes. The Canada–U.S. tax treaty contains some adverse provisions that need to be dealt with in the case of unlimited liability companies (see Section VII, "Tax").

1.1.3 What are the specific procedures for incorporation? How long does the process take?

A corporation is formed in Canada by filing certain prescribed documents with the appropriate authorities under the *Canada Business Corporations Act* or the corporations act of one of the Canadian provinces (in Ontario, the *Business Corporations Act*).

The most important document under the *Canada Business Corporations Act* and similar provincial statutes is the "articles of incorporation," which sets out the name of the corporation, its share capital, any restrictions on share transfer, the number of directors and any restrictions on the business to be undertaken. In British Columbia, the "notice of articles" sets out the company's name, its authorized capital, whether a class of shares has any special rights or restrictions, the names and addresses of the company's directors, and the "articles" govern the conduct of the company's internal affairs. In most other jurisdictions, matters in the "articles" of a British Columbia corporation are dealt with in bylaws passed by the directors and shareholders following incorporation. Under most statutes, corporations are given the capacity and rights of a natural person and it is not necessary to specify the objects for which the corporation is incorporated. The name of the corporation is strictly regulated in all jurisdictions to avoid names that are too general or misleading. There is a government screening process in some jurisdictions and it is sometimes possible to pre-clear a name prior to application for incorporation. In addition, the Quebec *Charter of the French Language* requires that a corporation carrying on business in Quebec use a French version of its name. Once the required documents are filed and fees paid, incorporation is automatic. The corporation comes into existence on the date of issue of a certificate of incorporation by the regulators.

The government cost of establishing and maintaining a Canadian corporation is relatively modest in most jurisdictions. In Nova Scotia, however, the fee to incorporate an unlimited liability company is much higher than average, as is the annual fee. Modest registration fees may also be payable upon commencing business in various provinces.

1.2 Supervision and management of a corporation

1.2.1 Who is responsible for the corporation?

A Canadian corporation acts through its board of directors and officers. The directors are elected by the shareholders, and subject to any "unanimous shareholders agreement," manage the business and affairs of the corporation. Unanimous shareholder agreements are discussed in Section III.1.2.2, "Residency requirements for directors or unanimous shareholder agreements." Corporate statutes may require that a certain number of Canadian directors be present. Under

the federal statute, at least 25 per cent of the directors at a meeting must be resident Canadians or, if there are fewer than four directors, at least one must be a resident Canadian (other than for corporations engaged in certain prescribed business sectors, which require a majority of the directors present to be resident Canadians). There are a number of general rules governing the qualifications and number of directors, such as a requirement that each director be at least a specified age and not bankrupt, but (unlike many other countries) there is no requirement that the director hold any shares in the corporation unless the incorporating documents provide otherwise. These rules apply equally to non-resident and resident directors. There are also additional rules that relate only to directors of public corporations. Under the Ontario statute, a private corporation must have at least one director, and a public corporation at least three.

Directors and officers have a duty to act honestly and in good faith with a view to the best interests of the corporation. They must exercise their powers with due care, diligence and skill, and must comply with the governing statutes, regulations, incorporating documents, and any unanimous shareholder agreements. They are also subject to conflict of interest rules. Where directors and officers neglect their duties, they may be subject to personal liability. They may also be subject to other liabilities, such as with respect to certain unpaid taxes and employee wages. A corporation may purchase and maintain insurance for the benefit of directors and officers for certain liabilities incurred in such capacity.

Directors appoint officers and delegate some of their powers to officers who conduct the day-to-day management of the corporation. It is rare for a Canadian corporation to have a “managing director,” although such a role is specifically recognized in some Canadian corporate statutes. The senior operating officer would generally be described as the “president,” with the chief financial officer often being the “vice president, finance” or the “treasurer.” Normally, there is also a secretary. One person may hold two or more offices, and officers need not be resident Canadians. Canadian immigration rules must be satisfied in respect of the transfer of non-resident employees to Canada to work for a Canadian subsidiary.

1.2.2 Residency requirements for directors or unanimous shareholder agreements

As noted in Section III.1.2.1, “Who is responsible for the corporation?”, the federal and the Ontario corporate statutes include a Canadian residency requirement for directors of 25 per cent, except where there are fewer than four directors, in which case at least one must be a resident Canadian. There are exceptions in the federal statute to this general rule for corporations in certain sectors. Some jurisdictions (being British Columbia, Quebec, New Brunswick, Nova Scotia, Prince Edward Island, Nunavut, the Northwest Territories and Yukon) do not impose residency requirements for directors. Alberta has passed legislation to eliminate residency requirements for directors and these changes will come into effect upon proclamation. Ontario has introduced a bill to do the same. There are no residency requirements for officers in any Canadian jurisdiction.

A foreign parent corporation will generally deal with the residency requirement of directors in the following way. It may find Canadian individuals to represent it on the board of the subsidiary, either Canadian resident employees or professional advisers (who will generally seek indemnification from the parent for agreeing to act). In some cases, the foreign parent will take the further step of entering into a “unanimous shareholders agreement” with respect to the corporation. Many Canadian corporate statutes (including the federal and Ontario statutes) provide for such agreements, under which the powers of the directors to manage the corporation’s business and affairs may be transferred in whole or in part to its shareholders. To the extent that the directors’ powers are restricted, their responsibilities and liabilities are correspondingly reduced and transferred to the shareholders.

1.3 How may a corporation be capitalized?

1.3.1 Shares

A share represents a portion of corporate capital and entitles the holder to a proportional right to corporate assets on dissolution. Shares must be fully paid before they can be issued (although calls on shares are permitted in Nova Scotia and Prince Edward Island, as well as under Quebec law for certain pre-existing companies). Under the federal statute and the corporate statutes of most provinces, a corporation is prohibited from issuing shares having a par value.

There is no minimum or maximum amount of share capital that a corporation can issue, unless otherwise specified in its incorporating documents. “One shareholder” companies are permissible under Canadian law.

Canadian corporate law provides great flexibility in developing the appropriate capital structure for a corporation. The articles of incorporation specify the permitted classes of shares and their key terms. Shares may be voting or non-voting, or they may have limited voting or disproportionate voting rights. The incorporating documents may attach various conditions to the payment of dividends and will stipulate rights on dissolution of the corporation. Absent specific provision in the articles, under the Ontario and federal statutes, shareholders do not have any pre-emptive rights in respect of future share offerings.

Redemption or purchase of shares by a corporation and payment of dividends are subject to statutory solvency tests. Financial assistance by the corporation in favour of shareholders and other insiders is also regulated in some provinces but is no longer regulated under the federal or Ontario statutes.

1.3.2 Debt financing

Corporate capital may also be raised by borrowing. Directors may authorize borrowing unless the incorporating documents or a unanimous shareholders agreement restricts them. Restrictions upon corporate directors, however, will usually not protect the corporation against third parties in the case of unauthorized borrowing by directors. Corporations also have the power to grant security interests over their property and to give guarantees.

1.4 What are the basic procedures governing shareholder participation?

Shareholder meetings are usually held annually in a place determined by the directors or stipulated in the documents that govern the corporation. At the annual meeting, the financial statements for the year will be presented to the shareholders and any necessary resolutions passed (such as for the election of directors). Some corporate statutes require meetings to be held in their jurisdiction unless the documents that govern the corporation provide otherwise or the shareholders agree to hold meetings elsewhere. However, shareholders may act by way of written resolution rather than at a meeting. The practice with respect to non-resident wholly owned subsidiaries is for all shareholder matters to be carried out through written resolutions. Where a corporation has only one class of shares, each share entitles the holder to one vote at all shareholder meetings. Where there is more than one class of shares, the voting rights are set out in the articles of incorporation. Shareholders may vote personally or by proxy.

2. Corporations and Partnerships in Canada

In Canada, a partnership is not a separate legal entity but a relationship between persons (which may be individuals, corporations, trusts or other partnerships) carrying on business in common with a view to profit.

A corporation is free to enter into partnerships in Canada. The resources each partner contributes to a partnership would commonly be money, but could also be skills, labour, intellectual property or other property. The relationship of the partners is established by contract and is also subject to applicable provincial laws. Some provinces require that partnerships be registered. A partnership may take one of three forms, a “general partnership”, a “limited partnership” or a “limited liability partnership”.

Subject to the terms of their agreement, all partners in a general partnership are entitled to participate in ownership and management, and each assumes unlimited liability for the partnership’s debts and liabilities. To the extent that each partner in a general partnership is itself a limited liability corporation, the liability risk for such partners would be reduced (but not eliminated).

In a limited partnership, there is a separation between the partners who manage the business (general partners) and those who contribute only capital (limited partners). A limited partnership must have at least one general partner, who will be subject to unlimited liability for the debts of the partnership. Limited partners are liable only to the extent of their capital contribution to the partnership provided they do not participate in the management of the business.

A third type of partnership is the limited liability partnership (LLP). In Canada, a limited liability partnership is only available in certain provinces, is governed by specific provincial legislation and is often only available to groups of professionals, such as lawyers, accountants and doctors. In British Columbia (unlike other provinces), any kind of business may be carried on through an LLP. A limited liability partnership is a general partnership in which the liability of its partners is limited. This type of partnership provides greater liability protection for partners as only the assets of the partner who worked on, or with, a particular client would be at a risk if that client sued the partnership (and the assets of the other partners would be protected).

A partnership would generally be entered into by a foreign corporation, directly or through a subsidiary, only if it wished to establish a joint venture arrangement with another person or corporation. The income or loss of the business will be calculated at the partnership level as if the partnership were a separate person, but the resulting net income or loss will then flow-through to the partners and be taxable in their hands. Partnerships themselves are not taxable entities for Canadian income tax purposes. Because of its flow-through nature, a partnership might be appropriate if a joint venture business is expected to generate disproportionately large expenses in its early years, as the partnership structure would allow the individual co-venturers to take advantage of the tax write-offs arising from these expenses. In the case of a limited partner, the amount of losses which may be available is limited by the amount which the limited partner is considered to have “at risk” in the partnership.

3. Joint Venture Structuring

Two or more parties may engage in a joint venture or syndicate where they collaborate in a business venture. There is no specific statutory definition or regulatory scheme for joint ventures, at either the provincial or federal level, although they are not uncommon in certain industries such as construction and natural resources. A joint venture generally denotes an association of two or more persons, usually governed by a contract, pursuant to which such persons agree to combine their money, property, knowledge, skills and other resources in furtherance of a desired venture,

typically agreeing to share the profits and losses, with each having some degree of control over the venture.

To help avoid the presumption that a partnership has been formed, the joint venture agreement should declare that a partnership is not intended. The agreement should also set out the scope of the venture and the method of control and decision-making. It should stipulate the rights and obligations of the participants and provide mechanisms for the settlement of disputes. Unlike a corporation, a joint venture is not a distinct legal entity. It cannot sue or be sued. Such rights and liabilities are attached to the entities involved in the joint venture.

4. Alternative Methods of Carrying on Business

4.1 Branch office

Organizations with foreign ownership may conduct business in Canada through branch offices, so long as the *Investment Canada Act* and provincial registration and licensing requirements are complied with. The foreign corporation must register in all provinces in which it will carry on business.

A branch office operates as an arm of the foreign business, which may enjoy tax advantages from such an arrangement. See Section VII, “Tax.” However, the foreign business’s liability for the debts and obligations incurred in its Canadian operations is not limited as it would be if the Canadian operations were conducted by a separate corporation (other than a British Columbia, Alberta or Nova Scotia unlimited liability corporation or company) of which the foreign business was the shareholder.

4.2 Agents and distributors

As an initial step, a foreign enterprise may wish to offer its products or services in Canada by means of an independent agent or distributor. An agent usually would be given limited authority to solicit orders for acceptance at the foreign head office, and would not normally take title to the goods or provide services to the customer. A distributor, on the other hand, usually takes title to the goods and offers them for resale, either directly to the customer or through dealers or retailers. In both cases, the foreign enterprise will likely seek to avoid establishing a permanent establishment in Canada for tax purposes. See Section VII, “Tax.”

The relationship with an agent or distributor should be established by contract. Although provincial law does not generally prohibit the termination of an agent or distributor, the courts will require reasonable notice to be given, or damages in place of notice, in the absence of an agreed contractual term for the relationship. The nature of the relationship should be reviewed to determine whether the arrangements are subject to franchise legislation. See Section III.4.3, “Franchising.”

4.3 Franchising

Franchising is not as heavily regulated in Canada as it is in a number of other jurisdictions, including the United States. In Canada, franchising is a purely provincial matter and, currently, six provinces have franchise legislation in effect: Alberta, British Columbia, Manitoba, Ontario, Prince Edward Island and New Brunswick. While there are slight differences in the legislation and regulatory requirements of each province, they are all ultimately derived from the U.S. model of mandated disclosure by a franchisor to prospective franchisees, coupled with a duty of good faith and fair dealing owed by each party to the other, and a right of franchisees to associate freely amongst themselves.

Unlike the U.S., no Canadian province requires either the registration of franchisors or the public filing of their disclosure documents. There is no government agency in Canada which is charged with the task of regulating or overseeing compliance with franchise legislation, with the result that there is no body (save the court) from whom any permission must be sought or any comfort may be obtained (regarding compliance with or the non-application of franchise legislation, the availability of a disclosure exemption or otherwise).

Put simply, a franchise relationship is an ongoing relationship that is found to exist under provincial franchise legislation where the franchisor grants the franchisee the right to use the franchisor's trademarks and other intellectual property and business methodology (typically at a specific location or within a specific territory only) in exchange for a fee. In a franchise relationship, the parties are independent contractors and neither party is an agent for the other, but the franchisor generally retains control over the use of its marks and a certain degree of control over the franchisee's manner of carrying on its business. This designation as a "franchise" is fact-based and occurs whether a company intends to operate as a "franchise" or not. Provincial franchise legislation in Canada defines "franchise" broadly and the term may apply to distribution arrangements not generally perceived to be franchises. As such, when utilizing distributorships or granting licenses in Canada, it is important to consider the implications of franchise legislation and the extent of a company's involvement in and/or control over the operation of the new distributor or retailer.

Among the most significant features of franchise legislation is the disclosure obligation which requires that franchisors deliver detailed pre-sale disclosure documents to prospective franchisees at least 14 days before an agreement is signed or any fees are paid. The disclosure document must contain all of the information prescribed by provincial regulations (which are substantially similar across provinces with franchise legislation) and any additional material facts about the franchise that could reasonably be expected to influence the prospective franchisee's assessment of the value of the franchise or decision to enter into a franchise arrangement. If the disclosure document does not comply with the legislative requirements, is delivered late or is not delivered at all, then the franchisee has the right for a specific period of time to rescind the franchise agreement and the franchisor is required to compensate the franchisee for all losses incurred in establishing and operating the franchised business (in addition, in certain provinces, to repurchase obligations). Franchisees can also bring a claim for damages for misrepresentation if the franchisor does not meet the applicable disclosure requirements.

Generally speaking, franchise legislation is remedial legislation enacted to protect franchisees and accordingly, it is not possible to contract out of its provisions. This means that properly identifying one's business as a franchise system that is subject to franchise legislation is an important step in determining the applicable legislative requirements.

4.4 Licensing

Licensing is a contractual relationship between two parties in which a licensor grants a licensee the right to use trademarks, patents or other intellectual property. While franchising typically involves the licensing of trademarks, know-how and the use of a franchise system, it is distinguished from pure licensing arrangements by the franchisor's control over the franchisees' manner of carrying on its business. The licensing relationship does not dictate the licensee's method of operation but would often establish standards applicable to the licensee's use of the licensed marks. The relationship is governed predominantly by the general law of contracts but the federal legislation regulating the relevant form of intellectual property would also be relevant.