

Should I Incorporate a Company to Operate my Franchise?

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by Murray Box

When considering entering into a franchise agreement, you have two options. You can sign on personally (as the franchisor will typically request) or you can arrange it so that the franchisee named in the franchise agreement is a company.

The Benefits of Incorporation

The primary reason for having a company enter into the franchise agreement (and related agreements, such as leases) is to shield you from, or at least reduce your personal liability under the agreements, as well as other liabilities that may arise in the operation of the franchise business.

Given that the law considers a company to be a separate person, you will not ordinarily be responsible for the things that the company does, even if you are its sole shareholder.

In addition, incorporating a company can allow you to structure things so that you can reduce your own income tax liabilities through 'income-splitting'. 'Income-splitting' is a term used to refer to the payment of money, by the company, to yourself and other adults, such as your spouse, parents, or children over the age of 18. The payment of money to a combination of shareholders typically results in the group paying less income tax overall than you would pay if the entire amount were to go to you.

In addition to income-splitting, if you eventually sell the company, and the shares are held by a combination of people, the group of shareholders may pay significantly less tax on the sale than you would pay if you were the only shareholder.

There are a number of rules and other factors to be considered in determining who can receive money from the company, how much each person can receive, how the payments must be characterized, and what tax must be paid on a sale of shares. A lawyer or accountant can explain the rules and also help you determine how the shareholdings in the company should be structured and how money should be distributed.

Directors & Officers Liability

Generally speaking, the directors and officers of a company are responsible for its management, and bear a corresponding legal obligation to ensure that the company complies with a wide variety of statutory rules.

For instance, directors and officers can be held personally liable if the company that they manage does not remit employee source deductions, goods and services tax, provincial sales tax, income tax, etc., or if it fails to comply with laws related to workplace safety and insurance, the environment, fire codes, etc.

Thus, even if you incorporate a company to operate your franchise, given that you will likely be responsible for its management, you will not be entirely free of liability for the conduct of the company. You will, however, be largely protected from liability arising under agreements with your franchisor, landlord, suppliers and service providers.

Creditor Protection

In this regard, it is usually a good idea not to name other family members as directors or officers of the company, particularly if they are not actively involved, as doing so will expose them to potential liability as well.

Note that shareholders (who are usually not subject to such liability) do not have to be officers or directors, so you can issue shares in the company to others without subjecting them to such risks.

Assuming that you are going to be a director or officer of the company, you should also consider strategies to shield your assets from seizure. Such strategies may include transferring ownership of personal assets to other family members, or to a trust or holding company.

A lawyer can help you decide how best to structure the shareholdings and management of the company to maximize the tax advantages while minimizing personal exposure to liability.

Personal Guarantees

As noted above, a franchisor will typically ask, and may in some cases insist, that you enter into the franchise agreement and related agreements personally.

In some cases, the franchisor will agree that, after doing so, you can assign the agreements to a company. Note that if you sign personally and then assign the agreements to a company, you will remain fully liable for the performance of the agreements unless you obtain a written release from the franchisor, landlord, etc.

If a franchisor or landlord agrees to allow a company to be the franchisee or tenant, as the case may be, the franchisor or landlord will likely ask that you, and in some cases, one or more of your family members, guarantee the company's performance of the franchise or lease agreement. Giving such a guarantee limits the extent to which you are protected from personal liability to the franchisor or landlord. As such, you should resist and, if a personal guarantee is required, you should try to ensure that the same is limited in terms of the kinds of things that you will be liable for, as well as the maximum amount for which you can be held liable.

A lawyer can help you negotiate with the franchisor or landlord to ensure that you are protected, as much as possible, from personal liability.

Conclusion

Even in cases where you are serving as a director or officer and providing personal guarantees, the use of a company will generally provide protection from liability to suppliers, service providers, etc. In addition, the potential tax savings will often make incorporating a company an attractive option.

In some cases, it may even make sense to incorporate one or more 'holding companies' which can be used to insulate funds and other assets from seizure by creditors, as well as to defer the payment of taxes.

The best option for you depends upon the nature of the franchise business, as well as your personal circumstances. In any event, it is a good idea to speak to a lawyer as early as possible when you are considering entering into, or renewing a franchise or lease agreement, so that the ideal structure can be put into place before you have to sign on the bottom line.

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