How should small business owners set up their finances as they start their company?

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Small business owners have a lot of considerations to make when setting up their businesses, ranging from whether to incorporate to how to collect sales tax.

Pandemic-weary Canadians thinking about launching a new business in the new year, whether it is a side hustle or a full-on career change, should know there's a lot to prepare for.

From questions about whether to incorporate to how to collect sales tax, a first-time entrepreneur will have to make many decisions at the outset to steer clear of financial mishaps.

Shadi McIsaac, chief executive officer of Ownr, an RBC Ventures company, said one of the first steps for an entrepreneur is deciding on their business structure: typically either as a sole proprietorship or a corporation. She said there are pros and cons to each approach.

"One of the biggest differences when you incorporate your business, it's no longer simply an extension of your work," Ms. McIsaac said. "It actually becomes its own distinct legal entity."

Some of the advantages to incorporation include making it easier to raise capital from investors and financial institutions, and to do business with the government. It's also easier to transfer ownership of the businesses, for instance in a sale, or with legacy and estate planning.

A sole proprietorship may be less hassle if the entrepreneur is working alone and is responsible for all facets of the business. Being a sole proprietor also means not having to pay the sometimes costly fees, including a lawyer's services, that can come with forming a corporation, though some new services, such as Ownr, can help guide entrepreneurs through the process at a lower cost.

Steve Bridge, a certified financial planner at Money Coaches Canada, said first-time small-business owners shouldn't feel a rush to incorporate. He said he's seen many clients incorporate too soon.

"There's no advantage for most people when they're starting out," he said. "Unless you are in an industry or profession where there's a good chance of getting sued or serious liability issues, then there's not a huge advantage."

Mr. Bridge said most small-business owners should think about incorporation once they find they are making much more money than they need to operate. At that point, he said, there can be tax advantages to keeping money in a corporation.

Taxes are a big issue when starting a new venture and come in two main forms: sales tax and income tax.

Sales tax is the easier one to keep track of. New businesses only need to collect the GST or HST if they make more than $30,000 in revenue in 12 consecutive months. Once that threshold is reached, a small business will then have to start collecting sales tax from customers. Rates vary by province and the timing of when that money has to be remitted to the government depends on the size of the business. Most small businesses will only have to remit once a fiscal year.

Liz Schieck, a certified financial planner at the New School of Finance, recommends opening a separate bank account for the sales tax to keep track of it.

“Every time you get paid from a client, you carve off that HST … and you put it in that account and you don’t touch it,” Ms. Schieck said.

How much to save for income tax is a bit trickier and depends on revenue projections. Ms. Schieck said she advises clients to err on the cautious side by assuming a tax bracket at least as high as the one they are currently in. Then, like the amount collected for sales tax, put a percentage of every paycheque into that account.

“It’s nicer to get to the end of the year and have more money in the tax savings than what you owe, rather than the reverse,” Ms. Schieck said. “Because then it’s kind of like, ‘Oh, I got a tax refund from myself.’ But it’s very unpleasant if it’s the other way around.”

Ms. Schieck said one of the most common financial pitfalls she sees from new entrepreneurs is undercharging for their services, which is important for both their business planning and personal finance planning.

“It’s really hard, especially when you’re just starting out, you don’t want to be the most expensive person,” she said. “You want to build your client base. But it can be really hard to raise your prices later if you work with repeat clients.”

Another big stumbling block for a new business can be keeping track of cash flow. That includes tracking when invoices are paid and expenses are due, to ensure the business is solvent.

“It’s the most boring part, but it’s the most important part,” Mr. Bridge said.

He recommended new business owners keep track of money coming in and out through spreadsheets, with many templates widely available online. For entrepreneurs that need help, they could look to hiring a bookkeeper or using an online service such as FreshBooks.

One of the biggest steps to protecting cash flow is to launch a business with a large financial cushion. Financial planners usually recommend having enough cash on hand to pay for three to six months of fixed expenses.

“Six months is ideal, but it can take a while to build up to that,” Ms. Schieck said.