BUSINESS STRUCTURES

Choosing the right business structure can have benefits and protections for legal obligations/liabilities, taxation matters and succession issues. Your choice of the correct or most appropriate business structure, will be influenced by the advantages and disadvantages of each structure. For example:

- Running a business as a **sole trader** maybe appropriate for very small businesses which do not employ staff (or very few staff) and which do not have significant commercial risks.
- For slightly larger businesses employing staff and/or being subject to higher levels of commercial and creditor risk, a **limited liability Company** is likely to be a more viable structure.
- Partnerships or joint venture arrangements may be appropriate for individuals or entities operating in the same business enterprise.
- A Family Trust and/or a commercial “trading Trust” - or combination.

We will expand upon each of these later on.

In the meantime, an example:

> You own a manufacturing business and a commercial building, from which you operate your business. Both activities are carried out under a “sole trader” structure in your own name. You also own a family home, perhaps jointly with your wife.

Of course, as an astute business person you will be well aware of the potential liabilities under the Fair Trading Act, Consumer Guarantees Act, Sale of Goods Act, Employment Relations Act, Resource Management Act, and the many legal remedies available to third parties under this legislation. In the event of a big legal claim against your business, you could potentially lose everything! So how to reduce the risk or minimise your potential loses? Perhaps you could operate the manufacturing business through a limited liability trading Company. The commercial premises could be owned by a separate limited liability (property owning) Company, or a Trust. Perhaps your other assets (family home, holiday home etc) could be owned by the same, or a separate Trust.

So - if a customer or third party sues the business then a claim made against the trading Company can only be satisfied/paid from the assets of that Company. As a result of this structure, your family home and commercial premises are likely to be safe from attack. This structure can offer a high degree of asset protection, namely:

- The family home and commercial premises are isolated from claims made against the business.
- If a claim is made against you as a Director of the business (that is a claim made against you personally), the family home and commercial premises will remain protected as these assets are not owned by you personally, they are owned by a Trust or Trusts.

Remember: when considering structures for commercial and business activities, it is important to realise that a whole range of structures are available depending on your taxation and commercial requirements.

SOLE TRADER

A sole trader is a person conducting a business or commercial activity (usually of a modest size) in their own (sole) name.

Advantages:

- A sole trader entity is simple and involves minimal set up costs and administrative requirements.
- You will have the sole responsibility of the business. Also you should be able to access tax losses arising from your trading activities.

Disadvantages:

- From a commercial prospective, a sole trader does not have the advantage of limited liability that is available to owners of Companies. If a sole trader's business fails, the sole trader will be personally liable for all debts.

- As a result of being liable for these debts, your other assets (home, cars, etc) may be at risk.
- As a business grows in size, a more sophisticated business or commercial structure may be required.

If you do operate as a sole trader, you should consider having your personal and investment assets owned in a Trust.

PARTNERSHIP

A Partnership is two or more people (or Companies) carrying on a business or commercial activity with a common view to making a profit. The terms of the Partnership are normally recorded in a Partnership Deed. A Partnership is not a separate legal entity (it exists as individuals trading together in “Partnership”); the profits and losses of the Partnership are attributable to the individual Partners and it is the Partners who are responsible for the tax obligations of their Partnership.

Advantages:

- Reasonably straight forward documentation.
- Profits attributable to the individual Partners and losses passed through to individual Partners.

Disadvantages:

- All Partners in the Partnership are jointly and severally liable for all liabilities of the Partnership. This means, as a Partner, you can be liable for debts incurred by another Partner on behalf of the Partnership.
- A Partnership (like a sole trader) does not offer the protection of limited liability. As a result, your personal assets can be used to satisfy debts incurred by the Partnership.
- A change in Partners or Partnership interests means the creation of a new Partnership and creates “deemed disposal” of the assets of the Partnership.

A Partnership can be the ideal business structure if there are a number of participants involved and potential liabilities are not a major issue. If you operate through a Partnership structure, you should consider using an asset protection Trust to hold your personal and investment assets.

COMPANY

A Company is a separate “legal person” and exists as a legal entity in its own right.

Advantages:

- The owners of a Company have the advantages of “limited liability”. If a Company fails, the owners of the Company will potentially only lose the value of the shares they subscribe for and the money they contributed for those shares. In practice, the benefit of limited liability is often reduced as the individual Directors and/or Shareholders are often required to provide personal guarantees in respect of Company borrowings, trading activities, leased premises etc.
- Companies provide a well-recognised and commercially acceptable structure for doing business.
- A Company structure can accommodate multiple owners with differing interests in the business, more easily than a Partnership.
- A Company structure is flexible. Changes in Shareholding (and ownership) can be implemented without changing the actual ownership of the Company assets themselves.

Disadvantages:

- Administrative requirements can be onerous (eg keeping a register of interests, a register of Directors Certificates, Share Register); requirements to pass Directors and/or Shareholders Resolutions for certain transactions and to keep Minute Books, produce financial annual statements and to file Company returns with the Companies Office.
- The Companies Act imposes strict duties and obligations on Company Directors. For example, satisfying the “solvency test” before making distributions to Shareholders. Third parties, customers, suppliers, lenders etc can sue a Director personally for breaches of those duties.

- Companies are regulated to a higher degree than other business structures. The Companies Act 1993 has increased the rights of minority Shareholders and imposes personal liability on Directors in certain circumstances.

A Company structure is recommended for any commercial activity involving a potential exposure to commercial liability. Such liability may include potential liabilities under the Fair Trading Act, the Resource Management Act and any duties or obligations imposed by statute. Accordingly, if you are Company Director you should look at obtaining Directors liability insurance and holding your personal/investment assets in an asset protection Trust.

TRUST

A Trust is a "legal promise" by one party (the Trustee) to hold and administer property/assets for the benefit of other people (the Beneficiaries), in accordance with the wishes of a third party (the Settlor) who settles/establishes the Trust. The conditions upon which the property/assets in a Trust is held, should be set out in the Trust Deed.

Income in the Trust will either be "beneficiary income" if it is paid out to the beneficiaries; or "Trustee income" if it is retained in the Trust.

Trusts are commonly used to hold and protect personal assets (eg family home) and investment assets (shares, commercial buildings etc). For a small family owned business a "trading Trust" could also be used for tax efficiency and as a convenient way of "involving" family members/beneficiaries. That is, Trusts provide a flexible means of distributing earnings to beneficiaries who in turn pay income tax at their marginal rates.

Advantages:

- Trusts provide opportunities for income splitting and utilising lower beneficiary marginal tax rates.
- Trusts provide protection for personal assets from creditors.

- They are an excellent vehicle for family and Estate planning purposes, especially matrimonial/relationship property disputes; and when family members are on benefits or beneficiaries are means tested.
- Trusts can provide for a smooth transfer of assets to family members, and provision/succession for future generations.
- Trust structures are also flexible. Trust Deeds can allow Trustees to "resettle" an existing Trust or Trust assets into a new Trust, if circumstances require it - depending on the beneficiaries needs.

Disadvantages:

- Even with Gift Duty abolished, assets still need to be "gifted" to be transferred to a Trust, at fair value. In doing so, the donor/transferor will need to be solvent and may need to satisfy future authorities that the gift/transfer has not been carried out to avoid obligations to creditors and/or spouses (relationship property) or any other third party.
- Trusts can be expensive to set up and require on-going administration.
- Resettlements of Trusts may have tax consequences: depreciation recovery, use of tax loses, GST and accrual rules consequences, income tax on land transactions, unutilised tax loses.

A Trust structure is recommended where family assets are exposed to commercial risks.

RSM Law Limited
Lawyers
TIMARU