

# Legal Torque

## Choosing the Right Business Structure

- Catherine Bormans -

### Introduction

If you are intending to buy or establish a business, you will need to consider how you should structure it. Even if you are already operating a business, you should consider whether the business structure you have in place is the one that best suits your needs. There are many factors to consider to ensure that you have the best structure in place for you.

A lot of small businesses operate as sole traders or partnerships however there are benefits to incorporating a company including limiting the liability of the business to the assets of the company alone (so as not to include your personal assets).

You should ensure that the business structure you have in place is the one that best suits your needs.

### Business Structures

The options for structuring a business are:

- Sole trader;
- Partnership;
- Joint Venture;
- Company;
- Trust.

### Factors to Consider

There are many factors to consider when deciding which business structure to use. Some of the factors to consider are:

- The owner's liability for debt incurred and for other legal obligations assumed;
- The funding arrangements;
- The tax implications;
- The number of people who will be involved;
- How the business will be managed;

- How the owner or owners will contribute to the capital of the business and how they will share profits;
- Whether the business is for a one-off project or whether it is expected to continue.

### Sole Trader

Operating as a sole trader is the simplest form of operation. The owner personally owns all the assets and receives all the profits but is also personally liable in respect of all the debts and losses of the business.

To be a sole trader it is not necessary to register a business name and there are no particular legal formalities involved.

The biggest disadvantage of being a sole trader is that the person has unlimited liability for the debts of the business. To an extent a sole trader can seek to protect themselves against this by transferring personal assets into a family trust. In this way, assets held by a trust are not generally available to the creditors of the sole trader.

The income earned is treated as personal income and is simply part of the sole trader's income. There is the disadvantage however that there is the potential for having to pay greater tax as the highest marginal tax rate for individuals is higher than that for companies.

### Partnership

A partnership is where two or more people carry on business together with a common purpose.

There are no particular legal formalities for a partnership although a written partnership agreement will help to avoid problems in the future. The Partnership Act 1908 will apply and under that Act a partnership is defined simply

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as two or more people carrying on a business in common with a view to profit.

Unlike a company, a partnership is not a separate legal entity. It must however be registered with Inland Revenue and file an annual return of income showing assessable income and how it has been divided amongst the partners.

A partnership can trade using any name it chooses provided of course the name used does not breach any law such as the Fair Trading Act and that it does not breach anybody else's rights to that name.

One disadvantage to operating a partnership is that each partner is liable for the partnership's debts, that is, if the partnership is unable to pay a particular debt then any one partner may have to pay the entire debt and not just their share.

### **Joint Venture**

A joint venture, like a partnership is also considered not to be a separate legal entity. A joint venture differs from a partnership in that the parties will not automatically be jointly liable as a matter of law. Liability amongst joint venture partners will largely depend on what each person agrees under their contract. The contract alone governs the parties' relationship.

### **Limited Liability Company**

A limited liability company is a separate legal entity. This means that a company is distinct from its owners or shareholders and the company has the rights and obligations of a natural person. Among other things this means that the company can sue and be sued in the name of the company as if it were an actual person.

There are certain formalities in registering a company and there are ongoing administrative formalities and expenses such as filing annual returns, forms to be lodged with the Companies Office when directors are replaced and so on. There are fairly stringent legal requirements under the Companies Act 1993 to comply with.

Once incorporated it is the company that is responsible for the business debts and obligations, not the shareholders or directors. Although a company structure does confer limited liability in principle, this is watered down because in reality shareholders are often asked to give personal guarantees to banks and other suppliers for the company's obligations. Directors may also be personally liable in certain circumstances such as when they have allowed the company to trade when it was unable to pay its debts.

### **Trading Trust**

Another possible business structure although not popular in New Zealand is that of a trading trust. A trust is an arrangement whereby one party holds the property (the trustee) for the benefit of another (the beneficiary) for some specified purpose. Trusts are commonly used for protecting family assets. With respect to a business, those who own the business are separate from those who receive the benefit of the income from the business.

The advantages to this structure are that there is limited liability if a company is a trustee and there is a great deal of flexibility in the distribution of income to beneficiaries.

The disadvantage to this structure is that entering into financial arrangements can be difficult as trusts as a business vehicle are less common than companies.

### **Conclusion**

There are advantages and disadvantages in each of the different types of structures. It is a matter of balancing the pros and cons of the various structures with your particular business' needs.

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