Fact sheet: Business structures

Business structures — options and features

There are four main structures used to operate a small business. These are: —

- Sole Trader
- Partnership
- Company
- Trust

The type of business structure you choose will affect your taxation position, your personal legal liability, the life of your business, and the availability of capital to establish and operate your business. It is therefore important to make the right choice.

Features of operating as a Sole Trader

- The taxable income of the sole trader includes the entire taxable income of the business
- A sole trader is able to pay a spouse a salary or wage, but must obtain advance approval from Inland Revenue as to the value of that salary or wage
- The sole trader is personally responsible for any business debt or loss and any business creditor will therefore have the right to claim against the sole trader's personal assets (such as the family home) to enforce a right of payment
- The operational life of the business is limited. When the sole trader dies, the business organisation will come to an end automatically, unless otherwise provided for in a will

Features of operating as a Partnership

- The taxable income of the business is split between the partners. The partners pay tax at their individual rates on their partnership income. Husband and wife partnerships are reasonably common
- The terms of the partnership are usually set out in the partnership agreement. if there is no such agreement, which is common for husband and wife partnerships, the partnership is then governed by the Partnership Act 1908
- A partnership is not a legal entity separate from the individual partners. The members of the partnership are therefore personally liable for all partnership debts. Since partners are legal agents for each other, it is important to choose your partner or partners carefully
- There is a presumption that partners will be jointly liable for contracts made by any one partner and that they will be jointly and severally liable for costs or any wrongful act committed by one partner
- A partnership can be terminated or dissolved in a number of ways. Subject to any contrary clause in a written partnership agreement, the death or bankruptcy of a partner will automatically result in the partnership being dissolved. In certain circumstances, a partner can apply to the court for a winding up order. for example, if one of the partners is of unsound mind, has been guilty of continuous misconduct, or if the business is continuing to run at a loss
- In certain circumstances (for example where there is a partnership involving a venture capital partner) a 'Limited Partnership' may be available. A Limited Partnership is a separate legal entity but retains the flow-through tax treatment for the partners. A requirement of a Limited Partnership is that there is at least one limited partner (a passive investor) and a general partner (who manages the business and are liable for the debts and obligations of the partnership)

Features of operating as a Company

- A company is a legal entity that is separate from the people who own it (the shareholders)
- A company is taxed separately from its owners at the corporate rate of 28%
- Company directors have many statutory obligations and various common law duties and responsibilities. All companies are governed by the Companies Act 1993. It is from this Act that directors derive these powers, obligations and duties. They must act honestly and in good faith for the benefit of all the shareholders and must exercise care, diligence and skill in performing their duties. if a company director breaches these statutory duties, he or she can be fined and/or sued by a shareholder
- In general, company directors are only liable for the company's debts to the amount outstanding on their shares, or to the amount of any personal guarantee given by them. They can however, be personally liable for the debts of the company, if the company continues to trade when it is insolvent

Features of operating as a Family Trust

- A typical trust has a settlor, a beneficiary, at least one trustee, (who is given wide discretionary powers to distribute income and assets amongst the beneficiaries of the trust and to carry on the business) and a trust deed, (the set of rules that governs the operation of the Trust)
- Most trust deeds give the business owner the power to remove a trustee and appoint a fresh one. This power of appointment gives the owner of the business a high degree of indirect control
- Trusts are becoming an increasingly popular form of business structure because they are a flexible means of distributing income and assets amongst various beneficiaries
- Trustees are governed by the Trustees Act 1956 and have significant obligations to the beneficiaries of the Trust. A trustee should be fully aware of his or her obligations before accepting any appointment as a trustee

Trustees can be held liable for the debts of the Trust, including directors of corporate trustees where they have failed to act in accordance with the Companies Act

Our Recommendation

The choice of the correct business structure can be of critical importance to the success or failure of the business.

It is always wise to seek legal and accounting advice as to the relative initial and ongoing costs of each type of structure.

Certain types of businesses do not have the flexibility to operate under each of the entity types. For example, real estate agents are prohibited from operating under a company structure. It is therefore sensible to check in advance for any industry regulations that prevent a certain type of ownership structure for your particular business.

The following table summarises the advantages and potential disadvantages of each structure type.

Structure Type	Advantages	Potential Disadvantages
Sole Trader	• Low cost of entry • Easy to set up • No significant legal costs • Only one tax return required • No registration of name required (if trading under your own name)	• Personally liable for all business debts • When you die, the business entity dies

Partnership	• Relatively low cost of entry • No significant legal costs, unless Partnership Agreement required • No registration of name required (if trading under your own names) • Limited Partnership may be available for specific situations involving venture capital investors	• Partners are personally liable for all business debts • Partners are personally liable for debts incurred by other partners • There is always the potential for relationship problems • Limited succession assistance
Company	• Limited liability for shareholder, although becoming greatly reduced • Easy to transfer shares and therefore ownership, on a progressive basis	• Additional legal and accounting costs to set up • Slightly higher ongoing compliance costs • Knowledge of directors' responsibilities required
Trust	• Protection of assets • Trust is ongoing (life of 80 years)	• Additional legal and accounting costs to set up • Higher ongoing compliance work to administer properly • Knowledge of trustees' responsibilities required • Disgruntled beneficiaries have the power to sue later • Trustee personally liable for tax debt

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