
The Right Structure

As you are probably aware a business may be operated under a number of different structures. You may operate as an individual (a sole trader), as a partnership (with one or more other individuals), by using a limited liability company or some other specialised entity (such as a co-operative or trading trust).

Depending on the industry in which you wish to be involved or are involved, the size of your business, whether you are operating with other people and whether there are special tax or financial considerations, you will need to choose carefully the structure best suited for you.

Matters which will influence the choice of structure will include:

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| 1 | Type of business | 11 | Industry legislation |
| 2 | Duration of the venture | 12 | Control of the business |
| 3 | Cost of formation and administration | 13 | Reporting and disclosure requirements |
| 4 | Establishment time | 14 | Ability to sell the business |
| 5 | Number of owners | 15 | Taxation |
| 6 | Profit sharing arrangements | 16 | Type of assets owned by the business |
| 7 | Amount and type of capital required | 17 | Ability of business to expand |
| 8 | Other business interests Funding | 18 | Ability to wind up |
| 9 | Arrangements | 19 | Continuity of existence |
| 10 | Extent of personal liability involved in the industry | 20 | Ability to admit new investors / partners |

It may be that in purchasing a business from another person you inherited a certain structure, but it does not necessarily mean that it is the most appropriate structure for you.

Very briefly the various areas can be described as follows:

THE SOLE TRADER

The sole trader personally realises his profits, takes his/her losses, pays tax and bears legal responsibility. His borrowing powers are those limited to an individual and of course he/she owns all the business assets themselves. He/she carries complete responsibility for operating the business and for all debts and obligations incurred.

This is an appropriate structure for a small business particularly one which is service orientated and one in which there is no particular need for wider income distribution, protection from liability or asset protection.

PARTNERSHIP

The "partnership" on the other hand, involves two or more persons. They may be a husband or wife, or they may be a number of unrelated people whose complimentary skills will combine to form a business entity. The taxable income is divided amongst them on a predetermined basis, usually covered in a formal partnership agreement. The partners jointly own the assets, cover the liabilities and are responsible for all debts and obligations of the partnership. However, one partner can contract and bind the others and if one partner is unable to meet his or her share of partnership debts in the event the business closes down, other partners must contribute that share. The borrowing powers of a partnership are basically similar to that of a sole trader. Accordingly, a partnership is an entity which involves the maximum of trust and co-operation between the individuals involved.

The “partnership” operates with assets and liabilities recorded in the names of the partners (including the bank account). The day to day transactions of the partnership operate in virtually the same way as the sole trader but the management of the business is by agreement between the partners.

Again this can be an appropriate structure for a service orientated business, but has additional liabilities in terms of actions of individuals other than oneself. It is more difficult to manage as a number of equal views need to be considered when making decisions. It does not provide protection from liabilities (such as professional liability) or asset protection.

A LIMITED LIABILITY COMPANY

This is a separate legal entity formed under the Companies Act 1993 and can be recognised by the word “limited” in its name. It is in fact a very common form of business entity for small and, of course, much larger business organisations. In many ways the company is similar to a person, but it takes its form from the Act of Parliament under which it is formed.

Generally the company has the legal power to do anything that a natural person may do, but it cannot take actions which affect individual shareholders unless they are a party to that action. The shareholders simply contribute the capital and the company then owns the income and incurs the liabilities. Day to day operations are controlled by the Directors who are appointed by the shareholders.

A limited liability company has greater borrowing powers by the use of floating charges but certain information must be filed with the Companies Office as a matter of public record. A company must comply with a considerable amount of legislation which can be time consuming and costly to administer.

Profits and losses accrue to the company and these profits or losses are then dealt with in accordance with decisions made by the Directors. There are both advantages and disadvantages in the company structure and again it depends largely on the scale of the business in which you have an interest and the needs of that business as to whether this would be the right structure for you.

Advantages

Limited liability for shareholders i.e. unless the shareholder has signed a guarantee or in some other way commit themselves to cover a company debt, they can not be called on to find any shortfall should the company fail.

The ability to borrow is substantially better than other structures.

It is a vehicle whereby larger numbers of individuals (shareholders) can continue to finance a business operation.

It is a widely recognised vehicle and therefore relatively easy to operate under in the normal commercial world.

Under some circumstances there can be tax advantages. However, these are unlikely to be a driving force when deciding whether to form a company or not, as there are also disadvantages.

Transferability of shares means that individual shareholders may (under the rules set out in the company’s constitution) exit or enter the company as circumstances dictate. Therefore issues such as succession planning are easier to deal with.

Banks often prefer to deal with companies rather than individuals because of the improved security it provides them.

A company can sometimes have a marketing advantage over an individual due to the perceived (but not necessarily real) size of business.

Disadvantages

More expensive to operate than partnership or sole traders.

Directors (once elected) carry substantial liabilities effectively for all shareholders. In the family situation this may not be an issue, but for larger companies this requires good (but expensive) systems and insurance and also adequate payment to directors (directors fees).

Decision making is slower than that of the sole trader or partnership.

Taxation disadvantages can occur when shareholders wish to withdraw funds from the company in certain circumstances.

QUALIFYING COMPANY

A Qualifying Company is also a company formed under the Companies Act 1993 but is treated differently for tax purposes.

Only closely held companies can become Qualifying Companies, which can then effectively be treated like partnerships, i.e. the shareholders and the entity are effectively treated as one entity.

There is the opportunity to become a "Loss Attributing Qualifying Company" (LAQC) which allows shareholders to take advantage of the losses in the Company and declare these in their own tax return.

There are both advantages and disadvantages to the Qualifying Company regime and specific advice should be sought before proceeding as a Qualifying Company.

Advantages

All of the advantages for a normal company apply. In addition, the advantage of being able to attribute a loss (under LAQC) to shareholders is an advantage.

Disadvantages

The same disadvantages apply as those for a normal company. In addition, entry and exit of the LAQC status can be complicated.

Also shareholders must guarantee the tax obligations of the company.

A TRADING TRUST

Our brochure on Family Trusts explains in general terms, the formation and operation of a Trust.

A Trading Trust is no different in many ways as a Trust may (depending on the Trust Deed) enter into business.

This can be beneficial in certain circumstances such as where liability (eg medical) needs to be managed. However, there are liabilities for the Trustees and the use of a Trading Trust needs to be carefully considered and structured. Involvement of your Lawyer and Accountant are essential.

A CO-OPERATIVE

Under the Co-operative Companies Act certain groups can form a co-operative company. This entity enjoys the advantages and disadvantages of a normal company, but can, if it meets the criteria of the Act, enjoy certain privileges not available to a normal company. The main interest in a co-operative usually comes from a group of producers, often primary producers, who by grouping together can offer further process or market their primary production and improve their return. Profit attained in this operation can then be rebated to the producers before striking a company profit. This rebate can only be from profit generated by its shareholders, but is a tax efficient method of profit distribution. Legal and accounting advice are essential when considering the formation of a co-operative.

CONCLUSION

The above information is of necessity, very general and your individual circumstances need to be factored into any structure. Obviously any of the structures, or a combination, may be appropriate for your business.

There are other entities, such as Special Partnerships and Joint Ventures which your business may wish to become involved with. These tend to be for special 'one off' projects and should be considered on a case by case basis.

In general terms the more simple the structure the better, but careful organisation of the structure can provide optimum control, efficiency, liability minimisation and tax efficiency. Involvement of your lawyer and accountant are essential in deciding how to proceed.

We are happy to provide a free, no obligation independent assessment of your personal and business taxation obligations.

For further details contact any of the partners or www.mcp.co.nz.

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