Business Structures Guide

How to choose the best structure for your business

Introduction

Small businesses can be operated by the utilisation of a number of different entities including:

- Sole Trader
- Partnership
- Family Trust
- Company

If you intend to start a small business, discuss it with your chartered accountant and solicitor before business operations commence, prior to signing any contracts. It is essential to choose the most suitable type of entity to suit the personal circumstances of the business operators.

It can be expensive to switch from one business entity to another and there can be significant income tax implications from operating businesses in one entity as compared to another.

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Sole Trader

Introduction

There is nothing to stop you commencing business in your own name, e.g. John J Smith.

The sole trader category is a suitable entity for small-scale business operations employing the personal talents of the proprietor.

The owner of the business is personally liable for the debts of the business and all of the owner's personal assets can be utilised to pay business debts.

Limitations

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.

Taxation

The taxable income of the sole trader takes in the entire taxable income of the business.

A sole trader will pay tax on the business' taxable income based on their marginal tax rate. The current rates (2011/12 and subsequent income years) are:

Marginal income tax rates	Income band
10.5%	0 - $14,000
17.5%	$14,001 - $48,000
30%	$48,001 - $70,000
33%	$70,001 and higher

Assets

The sole trader normally owns the assets of the business in his/her own right.

Liability

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.

Advantages

However, for a small enterprise, the advantages for a sole trader include:

- 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)

Disadvantages

On the other hand, the disadvantages mean:

- You are personally liable for all business debts
- When you die, the business entity dies

Partnership

Introduction

Partnerships have long been an effective way of conducting business operations, either on a husband and wife basis or on an 'arm's length' basis.

In the normal partnership, the liability of partners is unlimited and extends to their private property as well as to the partnership assets.

The taxable income of the business is split between the partners and the partners pay tax at their individual rates on their partnership income. Husband and wife partnerships are reasonably common.

Liability

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.

In the normal partnership, the liability of partners is unlimited. Liability extends to their private property as well as to the partnership assets.

Under law, partners are jointly (together) and severally (individually) liable for the debts incurred in their business. They are liable for all the partnership's debts and obligations of a contractual nature. The liability is not simply for the proportionate share held. Many a partner has found him/herself meeting 100% of the debts because his/her other partners were incapable of contributing.

Obligations

Partners have an obligation in law to keep their fellow partners fully informed and to use information gained in the course of the partnership's business for the benefit of all partners.

Partnership agreement

A formal contract, written or oral, is not essential. However, it is desirable that every arm's length partnership has a written partnership agreement, prepared by a solicitor, which sets out the terms and conditions of the partnership and the rights and responsibilities of the partners.

If there is no such agreement - common for husband and wife partnerships - the partnership is governed by the Partnership Act 1908.

The parties to a partnership agreement are free to include any details they wish for the running of the business. It is recommended that copies be held by the partners, their solicitors, accountants, and bank.

See the next section for a checklist of what to include in a partnership agreement.

Taxation

A partnership is required to lodge an income tax return.

The taxable income or loss of the partnership is distributed annually to the partners in proportion set out in the partnership agreement (or if there is no agreement, then equally between the partners).

The partners are therefore liable individually for personal income tax on their proportion of income and are obliged to declare their share of income in their annual tax return.

However, if there is a loss from the partnership then their share will be

offset against other personal income prior to calculating taxable income.

Advantages	The advantages of choosing to form a partnership include: ▪ Relatively low cost of entry ▪ No significant legal costs, unless partnership agreement required ▪ Income is apportioned to partners in accordance with their share in the partnership as generally documented in the partnership agreement (can be based not only on share in partnership assets but also other factors such as partners performance in partnership business) ▪ No registration of name required (if trading under your own names)
Disadvantages	On the other hand, the disadvantages include: ▪ Partners are personally liable for all business debts ▪ Partners are personally liable for debts incurred by other partners ▪ Potential for relationship problems ▪ Limited succession assistance
Dissolution	A partnership can be terminated or dissolved in a number of ways. Normally, the death or bankruptcy of a partner will automatically result in the partnership being dissolved, unless the partnership agreement sets out otherwise. 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.
Limited Partnerships	In certain situations, a Limited Partnership may be available. Limited Partnerships are a separate legal entity but retain the flow through tax treatment of a partnership. A requirement of Limited Partnerships is that there is at least one limited partner (a passive investor) and a general partner (who manages the business and is liable for the debts and obligations of the partnership). Accordingly this structure may be suitable for venture capital investors providing capital to New Zealand based ventures.
Costs	Solicitors' fees vary tremendously. We recommend that you obtain an estimate from your lawyer.

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Partnership Agreement Checklist

	Items to be included	Notes	
1.	Names and addresses of the partners		☐
2.	The percentage interest that each partner will have		☐
3.	The name of the partnership		☐
4.	Business Trading Name		☐
5.	Prime purpose of the partnership		☐
6.	The length of time that the partnership will be in existence and/or when a review will be undertaken		☐
7.	The capital and expertise each partner will invest in the business		☐
8.	Whether or not there is a designated interest rate payable on those funds		☐
9.	Details of working partners' salaries and fringe benefits		☐
10.	Details of sharing in profits and how these profits can be drawn from the business by the partners		☐
11.	The management responsibilities of each partner		☐
12.	How decisions are to be made in the event of a tied vote among the partners (usually referred to an independent arbitrator)		☐
13.	Consideration as to how new partners can be admitted and how old partners will resign, retire or be dismissed. Also consideration of death or bankruptcy.		☐
14.	How is a withdrawing interest in the partnership to be valued?		☐

15. Does the withdrawal valuation include goodwill?		☐
16. If so, how is goodwill to be valued?		☐
17. Consideration of the circumstances which would dissolve the partnership and the ground rules covering the distribution of assets of the partnership		☐
18. Bank Account to be opened in the names of the partners		☐
18. All partners should be authorised to operate the partnership bank account		
20. On all business stationery the names of the partners or the business name should be stated		☐
21. All accounts with creditors should be in the names of the partners or in the business name		☐
22. Each partner should have the right to dispose of his/her partnership income as they see fit		☐
23. Funding of capital expenditure		☐
24. Frequency of partnership meetings		☐
25. Frequency of preparation of financial statements		☐
26. Allocation of partnership responsibilities		☐
27. Preparation Of Budgets And Cash Flow Forecasts		☐
28. Preparation of business plan		☐
29. Quality assurance system		☐
30. Systems manual for the business		☐
31. Treatment of intellectual property brought to the partnership or developed by the partnership		☐

Completed by:	______________________	Date:	______________________
Checked by:	______________________	Date:	______________________

Family Trusts

Introduction

Family trusts have become a popular way of conducting small business operations in New Zealand. There are a number of persons who form and operate the trust.

Settlor

This is the person who establishes the trust and signs the trust document. They may transfer property other than the initial settlement to the trustee to be held on trust.

The initial settlement amount is usually relatively small (usually less than $100) with more substantial assets being transferred or loaned after the trust has been settled.

It is important that the initial settlement is actually paid to the trustee.

Trustees

The trustees are responsible for all aspects of the day-to-day management, investment of monies etc., relating to the trust. Subject to the terms of the deed of trust the trustee can be a natural person or a company. The number of trustees will usually be determined by the deed of trust. The trustees have extremely wide legal and trust responsibilities for the administration of the trust.

The trustee holds assets for the benefit of the beneficiaries of the trust. The trustee of a discretionary trust generally has the power to make distributions of profits and capital to any beneficiary or beneficiaries.

Trustees are governed by the Trustees Act 1956 and owe significant obligations to the beneficiaries of the trust. A trustee should be fully aware of its, his or her obligations before accepting any appointment as a trustee.

Trustees (including corporate trustees) are liable for debts of the trust. Directors of corporate trustees need to ensure they fulfill their duties under the Companies Act, otherwise they may become personally liable for debts of the trust.

Trust deed

The trust deed is prepared by a solicitor or administered by an accountant or other person using a suitable precedent. It sets out:

- The purposes of the trust (i.e. who can benefit)
- What the trustee can do
- Investment powers
- Borrowing powers
- Period of the trust (cannot exceed 80 years)
- Names of settlor, beneficiaries, trustee and appointor(s)

Beneficiaries

Beneficiaries are those people for whom the trust was created. The beneficiaries of a trust can be divided into a number of groups:

- Primary beneficiaries – normally (but not necessarily) the settlors and present and future children
- Secondary beneficiaries - normally future grandchildren and great grandchildren
- Tertiary beneficiaries - other trusts, religious organisations, charities

	and so on ▪ Final beneficiaries are the beneficiaries who benefit at the end of the Trust
Business activities	The trust, through the trustees, can conduct virtually any type of business activity that is approved by the trust deed in basically the same way as any other business activity operates.
Appointor(s)	The persons who have the powers of appointment are stated in the trust deed. Subject to the terms of the deed of trust the appointor(s) have the right to add and remove trustees and beneficiaries, and to approve permitted changes provided for in the trust deed. The extent of these powers can be customised to suit individual circumstances.
Distribution of Profits and Capital Gains	The trustees of a discretionary trust decide how to distribute profits and capital. The trustee is not bound by any fixed or predetermined percentage of distribution.
Taxation	The trustee of a family trust pays income tax on taxable income that is not distributed to any beneficiaries. The trustee rate of tax is currently 33%. Income distributed to beneficiaries (other than minor children) is taxed at the beneficiary's marginal rate. Family trusts are a very effective structure for those people entering into a business who do not have existing creditor exposure, but wish to protect assets against future risks. The reasons for settling a trust include protecting assets from future creditors; protecting assets from future relationship breakups; preserving assets for a single limb of a blended family; and inter-generational asset protection. In the majority of cases any distribution from a trust to a child under the age of 16 will be taxed at the trustee's tax rate. Any net loss derived by a trustee cannot be distributed to beneficiaries of a trust in order to be offset against other income derived by them. The losses are carried forward to be offset against future earnings of the trustee.

Advantages	The advantages of a trust include:
	▪ Assets may be able to be protected from a variety of people and organisations, such as:
	  ▫ Creditors
	  ▫ Family
	  ▫ In limited situations, asset and income tested benefits and assistance
	▪ Income can be distributed or paid out for the benefit of family members
	▪ Care must be taken to administer balances owing to beneficiaries carefully. Any distributions that are unpaid can be demanded as well as being included in the property of the beneficiary for relationship property and other purposes
	▪ The trust is ongoing. It has a life of up to 80 years, unless it is wound

up and distributed earlier

Disadvantages

Disadvantages include:

- Naturally, there are additional legal and accounting costs to set up a family trust
- There are further ongoing compliance costs to administer a family trust properly. Tax returns and full financial statements must be prepared on an annual basis if the trustees own income producing assets. In addition, the trustee must maintain resolutions approving financial statements, beneficiaries' distributions, and all major transactions. These may also be minuted. The skills of a good accountant must usually be employed
- A good knowledge of trustees' responsibilities is required. It is not wise for anyone to agree to act as a trustee until they are fully aware of their duties and responsibilities
- Disgruntled beneficiaries have the power to sue trustees where trustees have acted in breach of trust. Whilst this is rare, it is happening more frequently and it reinforces the need to be fully aware of duties and responsibilities
- The IRD are able to pursue all trustees for debts of the Trustee regardless, even if a trustee is only acting in the capacity as corporate trustee

Trust Losses

Net losses incurred by the trustee in one year are generally available to carry forward against net income in subsequent income years. Losses cannot be passed on to beneficiaries.

Where the trust is a shareholder in a look through company (LTC), any losses from that LTC can be used against the trustee's net income.

Asset Protection

Property and investment assets can be segregated from any business venture of significant risk into separate trusts. Assets can be protected:

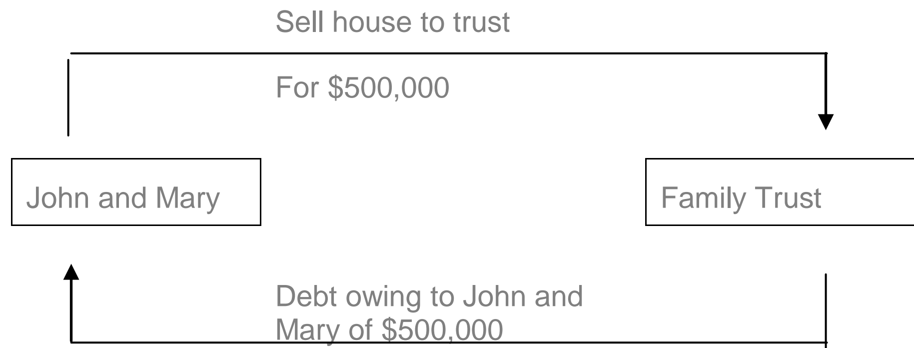
- From potential creditors
- In the event of a relationship property dispute
- For children's education
- So that in limited situations, government income/asset tested benefits are still available

The basic idea is for you to gift your assets to the trust. This can be done in a lump sum or progressively. Say for example you sell an asset (your family home) to the trust. Prior to the abolition of gift duty the usual arrangement was for an interest free loan to be made by you to the trust. The loan to the trust was then 'forgiven' by way of gift at the rate of $27,000 per annum per person without incurring any gift duty. A husband and wife or de facto or civil union partners can jointly reduce the loan at a rate of $54,000 per year.

A benefit here is that when John and Mary's house is sold to the trust for $500,000 any increase in value belongs to the trust, not to John and Mary.

Provided the trust is a fully compliant discretionary trust, the house should be protected. The debt owing to John and Mary of course will not be

protected until forgiven (gifted). The couple could suffer a business disaster but the trust assets can be legally separate, if the basic legal principles have been followed correctly.



Now that gift duty has been abolished, it is possible for assets to be gifted directly to a Trust without a gifting program. Whether assets should be gifted immediately or progressively will depend on the donors' circumstances. However, advice should be taken before any significant gifts are made to ensure there are no adverse consequences from the gift.

Matters to take into consideration before a significant gift include:

- Whether the gift will mean that any entitlement to a residential care subsidy (or other means tested benefit or allowance) might be compromised, either now or in the future
- Loss of control over the asset
- Whether the gift might have the effect of defeating a creditor's issues
- The donor's solvency
- Whether the gift could comprise relationship property

Distribution of profits

Once the trustee has made a distribution to a beneficiary (the distribution does not have to be by cheque - it can be a journal entry), then that money legally belongs to the beneficiary. The trustee may be empowered by the trust deed to utilise beneficiaries' current accounts for the benefit of the trust - with or without interest. However, any balance attributed to a beneficiary, together with any gains, remains that beneficiary's property.

Capital profit distribution

The trustee may have the discretion to distribute capital to various beneficiaries.

Claim on balance in current account

A beneficiary who is 'sui juris' (20 years old), can claim the balance in his/her name in the beneficiary's account. He or she is also entitled to request a copy of the financial report each year together with other trust documents.

Trustees' Responsibilities

A trustee's role is not necessarily onerous but does carry particular legal significance and specific responsibilities.

A beneficiary can sue a trustee for a wrong-doing whilst acting as trustee that constitutes a breach of trust.

Trustees may wish to notify beneficiaries of their status when each beneficiary attains the age of 20 years. However, in the absence of any provision in the deed of trust, there is no obligation at present to do so.

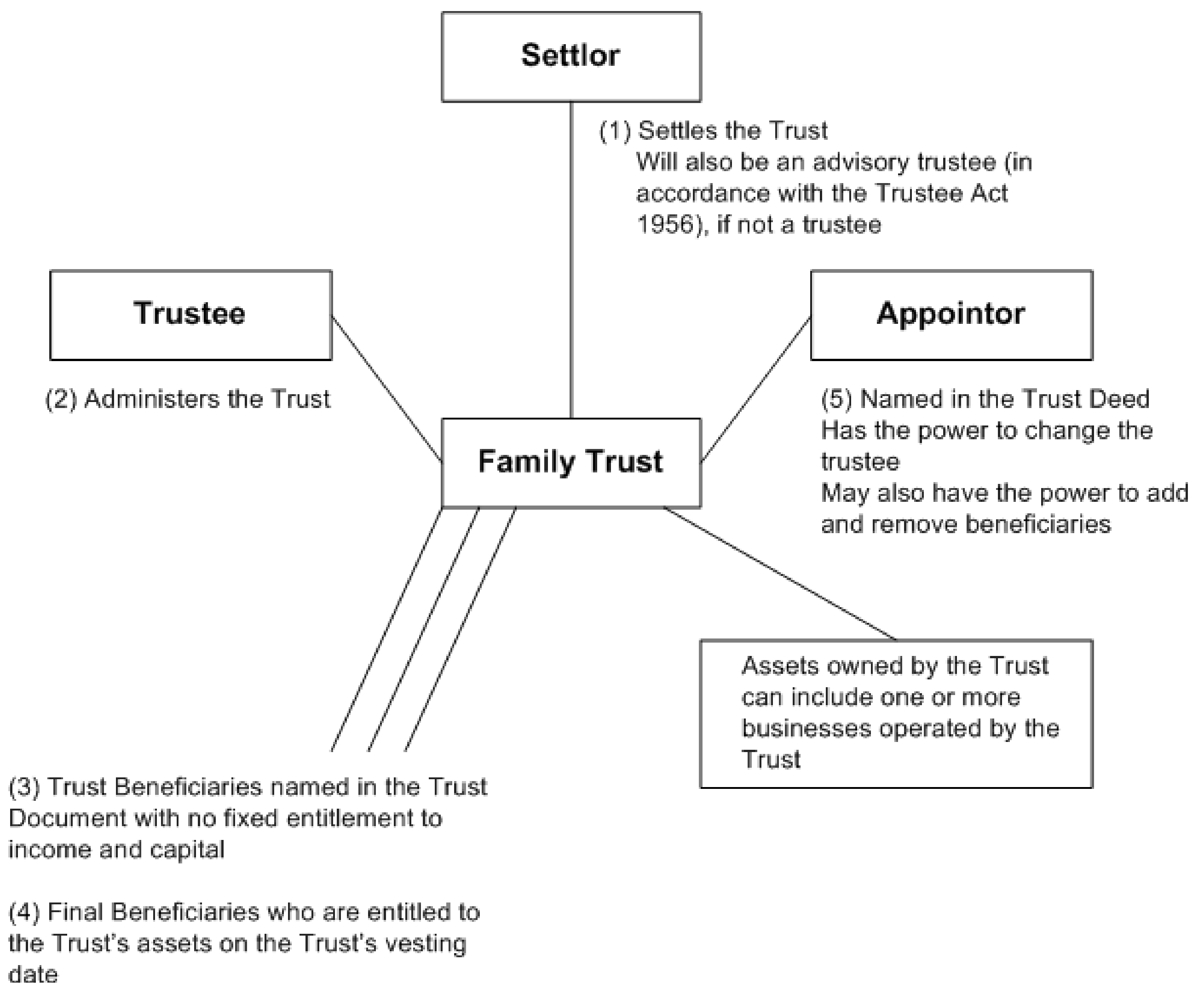
Trustee's decisions, whether made formally or not are called Trustee Resolutions. Good practice requires that each trustee resolution is recorded. Where a contemporaneous record of a decision is not made, the trustees should ensure that the minutes of the next trustee meeting record the resolution that was made.

Trustees' meetings should be minuted and the trust documentation should be carefully maintained. Some examples can be found in the section on trust minutes.

It is also imperative Trustees are aware of the extent of their liability for debts of the trust (including directors of corporate trustees)

If you would like to discuss what a trust would entail or what your responsibilities might be as a trustee, please contact us. And, of course, your solicitor can also advise you in this matter.

Discretionary Family Trust Diagram



Example: Minute recording the First Meeting of Trustees

Minutes of the First Meeting of Trustees

Of the [Client Name] Trust

Held at – [Location]

Present – [Name/s]

Trust Records

Resolved "That the Trust records be held at the offices of [Name, Address]."

Accountants

Resolved "That [Firm Name] is appointed accountants of the Trust. [Firm Name] are also to be instructed to obtain an IRD number for the Trust."

Solicitors

Resolved "That [Solicitor Name] be appointed solicitors for the Trust."

Bankers

Resolved "That a banking account be opened with [Bank] by lodging the settlement sum $[Amount] and that such account be operated in accordance with the bank authority, a copy of which is attached to these minutes."

Acknowledgement of Liabilities as Trustees

The trustees acknowledge their personal liabilities as trustees and that they have certain obligations under the Trustee Act 1956.

Beneficiaries

Prior to signing the Trust Deeds, the trustees have identified all current beneficiaries and have given due consideration of their current circumstances.

Payments on behalf of beneficiaries

Resolved "That in keeping with the objectives of the Trust, the Trustees are to make payments of expenditure on behalf of the following discretionary beneficiaries of the Trust, from time to time."

[Name]

[Name]

[Name]

[Name]

Trust Deed

Resolved "That the trustees have reviewed the Trust Deed and approve it for signing purposes."

Assets acquired

Resolved "That the Trustees purchase the property [Address] for $[Amount]."

Acknowledgement of debt to settlor

Resolved "That the Trustees sign an acknowledgement of debt to the settlors for $[Amount]."

Right of Occupancy

Resolved "That [Name], as beneficiaries, may reside in the dwelling at [Address] until such time as the Trustees decide to sell or lease the property, provided that they pay all costs of occupation and ownership including but not limited to rates, insurance, maintenance, interest, and light and power, such payments to be recorded as further advances to the Trustees."

Occupancy by [Name] shall not constitute a lease or any other interest in the property.

The decision to allow [Name] to reside in the property is in accordance with the Trust Deed and the Trust's investment strategy.

Signed by all the Trustees

____________________________ [Trustee]

____________________________ [Trustee]

Example: Minute distributing Trust Income for the year and approving Financial Reports

Annual Minute

[Trust Name]

Minutes of a meeting of Trustees held at [Firm Name], [Address] on [Date].

Present – [Name/s]

Financial Report

Resolved:

That the Annual Reports as prepared by [Firm Name], Chartered Accountants, showing a net surplus of $[Amount] made up of capital profit of $[Amount] and income of $[Amount] for the [Year Ended] be hereby adopted and approved.

In terms of the Trustees' resolution dated [Date] that income was allocated as follows:

[Beneficiary Name]	$[Amount]
[Beneficiary Name]	$[Amount]
[Beneficiary Name]	$[Amount]

Trustees	______	$[Amount]
Trustees	______	$[Amount]

Investments

Investments were reviewed by Trustees and it was agreed that the portfolio was appropriately structured in accordance with the investment strategy agreed [Date].

Beneficiaries

That prior to making the resolutions above, the trustees have given due consideration to the interests of all beneficiaries.

Signed by all the Trustees

______________________________ [Trustee]

______________________________ [Trustee]

Company

What is a Company?

A company is a legal entity that is separate from the people who own it (the shareholders). Every company is registered at the New Zealand Companies Office. This is a business unit within the Ministry of Economic Development.

Certain information regarding such things as ownership of a company is available to the public. This can be accessed over the internet from the Companies Office website http://www.business.govt.nz/companies

The main legislation governing companies is the Companies Act 1993. This sets out the requirements regarding the actual company and also the obligations of the people involved in a company.

Types of company

For tax purposes, three types of company structures exist for small/medium-sized businesses. These are:

- Standard Company
- Look-Through Company (LTC)
- Qualifying Company (QC) (now replaced by LTCs but QCs formed generally before 1 April 2011 can still exist)

An LTC may be a popular entity for certain small enterprises because losses can flow through to a shareholder. Profits are then taxed at the shareholder's marginal rate not the corporate rate.

Companies require additional documentation to be maintained.

Directors

Every company must have at least one director. Directors are the face of the company. They act on the company's behalf.

Company directors have many statutory obligations and various common law duties and responsibilities. The directors of a company must act honestly and in good faith for the benefit of all the shareholders. They 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.

Shareholders

Shareholders are essentially the owners of the company. Each company issues a certain number of shares. These are bought by shareholders.

Shares can be owned by an individual, jointly in partnership, by a family trust or by another company. Shares can be bought and sold easily. For companies listed on the stock exchange, this is best done through a share broker. For private companies, a share transfer form is completed detailing the transaction. This is retained by the company and notified to the Companies Office on an annual basis.

Advantages of being a company

While there are different types of companies, the advantages of company status generally include:

- Limitation of liability
- Ability to change ownership through trading of shares

Disadvantages of being a company

Disadvantages include:

- Stricter annual requirements, for example, to prepare minutes, file an annual companies return etc
- Higher establishment and ongoing costs
- It can be a lengthy process to dissolve a company
- Directors must understand and carry out their responsibilities

Liability

In general, shareholders of a company are only liable for the company's debts to the amount outstanding on their shares.

Directors of a company can be held personally liable for the debts of a company, if the company continues to trade while it is insolvent or if the directors have traded recklessly.

Often, in the case of smaller companies, shareholders will be asked to provide a personal guarantee to people or entities that are lending money to the company. This could be a bank, financier or supplier that is selling goods on credit to the company.

The bank, financier or supplier may not feel comfortable having only any unpaid share capital as the amount they are able to seek from shareholders in the unfortunate event that a company cannot pay its bills. They therefore request that the shareholders guarantee the debts of company.

Shareholders should consider the implications of signing personal guarantees carefully. By signing personal guarantees if the company cannot pay its debts, the personal assets of shareholders can be called upon to meet the company's debts.

Taxation

A company is taxed at the corporate rate of 28%, as at the start of the 2011/2012 tax year.

Often what happens in smaller closely held companies, is that once the annual profit for a company has been calculated, a decision is made as to how much of that profit should be credited to the shareholders of the company. This is done to remunerate them for the work they have done on behalf of the company.

Where dividends are paid to shareholders in most instances resident withholding tax (RWT) must be deducted from the dividend and paid to the IRD. The rate of RWT will depend on the specific circumstance and the amount of imputation credits attached.

Inland Revenue charges companies 'use of money interest' on any shortfall in taxation payments. This is at a rate that is usually significantly higher than the rate charged by the company's bankers. It is therefore important that any company that anticipates having tax to pay in the company's name, makes an early estimate of the amount payable and considers making a voluntary payment of tax. This will minimise the interest charge.

Look Through Company (LTC)	Certain types of companies can apply to the Inland Revenue to become a LTC. Generally these are smaller, closely held companies. The LTC rules are relatively new and provide for a transparent form of tax treatment for companies. This is to ensure that income and expenses are shared according to the owner's effective interest in the LTC. For income tax purposes, an LTC's income, expenses, tax credits, gains and losses are passed onto its owners, similar to the income tax treatment for partners in a partnership. The owners of an LTC are taxed on the profit of the company, as well as being able to offset losses from the LTC against their other income (subject to a loss limitation rule restricting the offset to level of the owners net investment). The owners are taxed at their marginal rate of tax. Shareholders become personally liable to pay any income tax owing by the company.
Qualifying Company (QC)	QCs have now been replaced by the LTC rules, and are no longer able to be formed. However generally QCs formed before 1 April 2011 can still exist. QCs are companies governed by tax provisions that allow them to attribute profits to its shareholders. Rules allowing certain QCs to attribute losses have been repealed (effectively being replaced by the LTC regime).
Company Formation	There are various methods to form a company. There are organisations that can help you form the company or sell you a shelf company. It is possible to form a company online on the Companies Office website http://www.business.govt.nz/companies You can also contact your accountant or solicitor. They are experienced in forming companies.
Dissolution of Companies	Once a company has ceased all operations it should be wound up. There is a formal process that must be followed. Contact your accountant or solicitor for further information.

Disclaimer

1. The report is a guide only and should not form the sole basis for any decision without first obtaining proper professional advice.
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   (b) For any errors or omissions in this report
   (c) For any direct or consequential loss or damage to arising from the use of this report, whether to a direct purchaser of this report or to any other person who may borrow or use them
   (d) If any part of the report, whether used in its original form or altered in some way by the user, proves invalid or does not attain the result desired by the user
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