AJPark

Commercial

Guide to structuring your business

This information sheet is a brief guide to structuring your business. It sets out the most common types of business structures. We also briefly outline an intellectual property (IP) holding structure that can protect your IP, and set out some issues you should consider when going into business with others.

Types of business structures

The most common types of business structures are summarised below.

Sole trader

A sole trader operates a business in his or her own name.

The business may have a trade name, but all of the contracts and obligations of the business are entered into in the name of the individual. This means the individual is personally liable for the debts and obligations of the business.

The business of the sole trader will be taxed at the individual's personal tax rate. The sole trader can offset business losses against other income earned by the sole trader.

A sole trader can lack credibility in the marketplace, and may find it difficult to attract investment funding.

For these reasons, while very common for small businesses, the sole trader is usually the least attractive business structure.

Company

Companies are easy to establish, have separate legal existence, and provide limited liability protection for directors and shareholders. They can have more credibility in the marketplace than sole traders, and find it easier to attract investment funding. It is usually easy to transfer ownership of a company.

A company's limited liability status means that in most cases shareholders and directors will have no liability for the debts and obligations of the company. The liability of shareholders is usually limited to the value of their shares. And if directors comply with their statutory duties, they will not generally be personally liable for the debts and obligations of the company.

However, a company's limited liability status is often eroded in practice by the need for directors or shareholders to provide personal guarantees to lenders or creditors.

A company's profits are taxed separately at the corporate rate. Profits are distributed to shareholders, often with imputation credits to ensure corporate profits are not taxed twice.

Joint venture

A joint venture involves two or more parties coming together to run a business. A joint venture may be incorporated or unincorporated.

An incorporated joint venture is established when the parties set up a separate company. The rights and obligations of each party are usually set out in the company's constitution and in a shareholders agreement.

An unincorporated joint venture (UJV) is a contractual arrangement between two or more parties, and is established and governed by an agreement between the parties (for example, a joint venture agreement). A UJV is not a separate legal entity, and the parties remain liable for the debts and obligations of the UJV. A UJV is not a separate taxpaying entity, and UJV profits are treated as the taxable income of the UJV parties receiving them. This means that UJV parties can offset UJV losses against other income earned by them.

A UJV may often also be a partnership, even where this is not intended.

Partnership

Partnerships are most common among professional people (for example, lawyers, doctors, and accountants), and involve two or more parties coming together to run a business and share the profits. Like a UJV, a partnership is not a separate legal entity, and each partner remains liable for the debts and obligations of the partnership.

Partners have special duties to each other. These are called fiduciary duties, and they include the duty to act honestly and in good faith.

A partnership is not a separate taxpaying entity, and partnership profits are treated as the taxable income of the partners receiving them. This means that partners can offset partnership losses against other income earned by them.

Partnerships have a number of disadvantages. A partnership is not a separate legal entity, so it can be difficult for a partnership to enter into contracts, and the partners remain liable for the debts and obligations of the partnership.

Limited Partnership

A limited partnership is a special type of partnership. A limited partnership is a separate legal entity that has most of the tax benefits of a normal partnership. It also provides some limited liability protection to partners.

Each limited partnership must have at least one general partner and, at least, one limited partner.

- The general partner has residual liability (meaning that if the assets of the limited partnership don't cover a liability, the general partner is liable for the residue).
- The liability of the limited partners is limited to the value of their capital contributions for the debts and obligations of the limited partnership (provided they don't engage in management of the limited partnership).

A limited partnership is not a separate taxpaying entity. Instead, partners are taxed in the same manner as partners of an ordinary partnership.

Limited partnerships are good vehicles for businesses where:

- some of the business owners are 'silent partners'
- an investment is expected to experience capital gains
- losses are likely to occur early on
- some participants have special tax status (for example, non-resident or tax exempt).

New Zealand and each State in Australia has its own laws governing limited partnerships, and some of the features above may differ depending on what territory you are in.

Unincorporated trust

An unincorporated trust is a trust where some or all of the trustees are individuals. Most family trusts are unincorporated trusts.

Unincorporated trusts have all the liability disadvantages that sole traders have. The tax treatment of trust income depends on the status of the trust and whether the income is regarded as trustee income or beneficiary income.

Business names

In Australia, if you are doing business under a name, you need to register that name. So, for example, if your name is Joe Smith but you are trading as Smart Business, you would need to register Smart Business as a business name.

There is no similar requirement in New Zealand.

Protect your IP by creating an IP holding structure

If you have a valuable IP portfolio, you should take steps to reduce the risk of that portfolio being attacked by creditors, or exposed to your business' day-to-day trading risks.

To do this, consider setting up a separate business structure to hold all of your IP. You may need to transfer ownership of your existing IP into the new IP holding structure. The IP holding structure would then grant a licence to a separate trading entity, so that the trading entity has the rights it needs to continue using the IP.

If your trading entity then fails, and if you set things up right, you may be able to take your IP, set up a new trading entity, and start again.

Setting up an IP holding structure like this requires you to carefully consider a number of issues, including tax. We have considerable experience in putting together these types of structures. We also work closely with external tax advisers, and can put you in contact with the tax experts you need.

Going into business with others

No matter what structure you choose, if you're in business with others, you should enter into an agreement with your business partners that set out how the business is to be run, and how you will deal with each other.

That agreement should address:

- how business decisions will be made
- how you will deal with disputes
- how you will manage departures from the business, or new investors
- non-competition and restraint of trade issues
- what contributions each party will make to the business.

We can advise you on the right type of business structure for you, and help you set it up. We can also take care of drafting shareholder agreements, partnership agreements, joint venture agreements, and limited partnership agreements.

Contact AJ Park's commercial team for help with structuring your business.