Structures

Choosing the most appropriate structure depends on your personal circumstances and your plans, both short and long term.

You may be influenced by factors such as creditor protection, the Property Relationship Act, the desire to minimise taxes or other matters.

The key is to sort out the most appropriate structure for your business at the beginning, as it may be difficult and expensive to make changes later.

Sole Trader/ Self Employed

Advantages:

- Simple – no administrative overhead eg no company annual return filing fees, only 1 tax return, don't need separate bank account and fees etc.
- All profits are allocated to you as taxable income.
- Can offset losses against other income easily.

Disadvantages:

- No opportunities to split income to reduce taxes when making profits.
- No opportunities to spread income/ losses over years to minimise tax liability ie all income is taxed in the year earned (and all losses offset in year incurred).
- Difficult to pass to future generations.

Partnership

This is 2 or more people or entities (up to a maximum of 25) operating or owning property together.

Surpluses and losses are allocated to partners in the year incurred according to their partnership share.

Advantages:

- Opportunities for income splitting.
- Can offset losses against other income easily.
- Greater source of finance than sole trader.

Disadvantages:

- No opportunities to spread income/ losses over years to minimise tax liability ie all income is taxed in the year earned (and all losses offset in year incurred).
- Need to complete a separate partnership tax return.
- Inflexible – can't change partners without dissolving partnership.

Trust

A person (the settlor) settles assets in a trust. This is usually done by the settlor selling assets to the trust. The settlor gives the trust a loan (interest free repayable on demand) to pay for the assets. Then the settlor progressively gifts the loan to the trust. This is done at the rate of $27,000 each year without incurring gift duty. There is usually a trust deed and trustees administer and invest the assets for the beneficiaries.

Advantages:

- Allows opportunities for spreading income among low-income beneficiaries (but children taxed at 33%).
- Can retain income and losses and choose when to pay out income.
- Maximum tax rate is 33% so distributions to beneficiaries on higher marginal tax rates are not further taxed.
- Can pay capital profits tax free.
- Provides a vehicle for retaining assets for future generations (without incurring depreciation recovery). This is done by changing beneficiaries (although if this is done frequently and unfairly beneficiaries can take the trustees to court if they feel they were unfairly excluded).

Disadvantages:

- High set-up cost – around $2,000.
- Potential on-going costs eg forgiveness of debt filing with IRD, separate income tax return etc.
- Can't pass on losses to beneficiaries.

Company

May be a minimum of 1 director who is also the only shareholder.

Advantages:

- Opportunities for income splitting among shareholders and directors on lower tax rates.

- Viewed as a more commercial entity than a Trust (Trusts are being monitored very carefully by both IRD and the government)
- Low set-up cost – $160 on line
- Can retain income and choose when to pay it out ie can spread income.
- Can pass ownership on to future generations through share transfers.

Disadvantages:

- Administrative overhead – preparation of company income tax return and filing annual return ($45).
- Losses must be carried forward.
- Cannot take out capital profits without liquidating the company. This is because any distribution from a company is taxable in the hands of the recipient (regardless of whether the distribution is of income or capital). This has huge implications if you sell a major asset!

Qualifying Company

- Needs to have 5 or fewer shareholders (although related parties eg husband and wife can count as one).
- Directors and shareholders make an election through IRD (use an IR436).
- Shareholders must agree to personally take on the company's unpaid tax liabilities.

Advantages:

- As for companies (ie income splitting and spreading, and can pass to future generations easily) but also,
- **Can distribute capital profits tax free.**

Disadvantages:

- As for companies (ie losses must be carried forward, on-going costs) but
- Have to give a personal guarantee to pay unpaid company taxes.

Look Through Company (LTC)

- Organised by election through IRD (IR862).
- The shareholders are treated as partners so any profit or loss is allocated to the shareholders according to their shareholding.

Advantages:

- Income splitting and spreading,

- Can distribute capital profits tax free) but also,
- **Can offset losses against personal income.**

Disadvantages:

- On-going costs,
- Any change in shareholding can trigger depreciation recovery unless a property cost less than $200,000,
- Profits must be distributed according to shareholding and cannot be retained in the company.

Summary

- Sole trader is the easiest option early on. However it limits opportunities to split or spread income (and reduce overall taxes) and to pass on income streams to future generations without the depreciation recovery.

- Distributions of capital profits from ordinary companies can not be made tax free but qualifying companies and trusts provide these opportunities.

- The advantage of a trust over a company is that it is easier to change the beneficiaries.

- The advantage of an LTC over a trust is that losses may be offset against shareholder income.

So… again it comes down to your short and long term plans as to which option you choose.

However for most business owners a **company** structure is:

- cheap to set up,
- looks commercially professional,
- provides ownership flexibility particularly for a sale and further outside investment,
- allows opportunities for losses to be offset against other income sources (if an LTC),
- allows capital gains on the sale of assets to be distributed tax free without winding up the company (if a QC or LTC),
- provides flexibility in profit distribution and therefore minimising taxes by enabling income splitting to lower rate tax payers and spreading income over years.

At the same time it may be appropriate to set up a family trust to own your family home or other appreciating assets to provide protection from creditors, potential property relationship issues, and to minimise taxes.

To minimise taxes you can sell most of your shares in the company to the family trust. After paying you and your staff market salaries (and sometimes 80% of the profit) the company can then pay a dividend to the family trust from tax paid profits. The dividend may then be distributed to beneficiaries and there are tax advantages for those beneficiaries who are on tax rates of less than 33% ie those over 16 years of age and earning less than $70,000 a year. As the company has already paid tax on the profits those tax credits are passed to the trust as imputation credits which means that beneficiaries don't need to pay any further tax on those funds. Unused imputation credits for beneficiaries on lower marginal tax rates will be carried forward to the next (and subsequent) years until used up.