Limited vs unlimited liability – considerations when choosing a business structure

Date: Sunday April 30, 2023

One of the first decisions a business owner will have to make is what corporate/business structure they will use to operate their business. A major factor that business owners must consider is whether they would like to limit their liability should the business incur unpayable debts or liabilities. The business structure chosen will determine if the owner(s) have limited or unlimited liability.

What some budding entrepreneurs don't realise is that assessing and selecting a business structure should start even before the business begins. As exciting as it is to be starting a new business, unfortunately, it's not just the glamorous decisions like logo design and business name selection.

What are the main business structures?

There are three main business structures in Australia:

- Sole Trader – the business owner has **unlimited liability**.
- Partnership – the business owner has **unlimited liability**.
- Company – the business owner has **limited liability**.

What is limited liability?

Businesses incur debts and liabilities in a variety of ways in the course of their operations. This could include through:

- bank loans or other debts;
- unexpected business expenses; and
- being sued.

In a company, the owner's (also known as the shareholder) liability is limited to the value of their shares. Although they may lose the value of their shares (or if their share price is unpaid, the shareholder may be required to pay up this amount), generally, they will not have to contribute any more money, liquidate any further assets or be otherwise personally responsible for the business's debts or liabilities.

What is unlimited liability?

In contrast to limited liability, in a sole trader or partnership business, the owner's personal assets and finances may be required to be used if the business is not able to meet its financial obligations or fails to repay its debts and/or liabilities.

In some cases, sole trader or partnership business owners have been required to sell assets, including their family home, personal vehicles, or jewellery, to cover the expenses or debts of the business.

How are debts and liabilities dealt with in limited vs unlimited liability structures?

Let's consider this scenario. A business has a debt of $10,000, but the business does not have any money. Sole traders and partnerships, who have unlimited liability, will have a different approach to this debt compared to a company, which has limited liability.

> *Limited liability – a business with a company structure*
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> In a limited liability business, if the owner owns, for example, $500 of shares, they may lose that $500 in shares but will not have to pay the remaining $9,500 towards the debt.
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> *Unlimited liability – a business with a sole trader or partnership structure*
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> In an unlimited liability business, the owner of the business will have to pay that $10,000 debt, even if it means the owner must sell some of their own personal assets, such as their family home.

> It is vitally important that entrepreneurs consider both their business and personal positions and financial situations before making any decisions in relation to their business structure.

Need advice about your business structure? Call us on 1800 001 339

This isn’t the only thing to consider though...

You’d be forgiven for thinking that, if the risk of unlimited liability is so high, then why does anyone choose the sole trader or partnership options? The short answer is, unfortunately, it’s not quite that simple.

Like many things in business, there are several factors to weigh up when making any decision. There are other factors that may mean a sole trader or partnership business may be more appropriate for some business owners. This includes the fact that a company is generally more expensive to set up and has a more structured framework of legal requirements from year to year.

Business owners must ensure they consider all the advantages and disadvantages of each business structure when making this important decision. Seeking advice from a commercial lawyer experienced in setting up a new business and assessing all the factors related to choosing a business structure is vital.

Get help from an experienced commercial lawyer and accountant when starting a new business

There are two primary professionals who can assist you in understanding your options when choosing a business structure. Crucially, they will be able to assist you to understand your personal situation in relation to limited vs unlimited liability. You should always seek advice and assistance from:

- your lawyer (we hear IM Lawyers are great); and
- your accountant.

It’s important that you consult **both** a lawyer and an accountant, as each has different expertise that is required to make the best decision for your personal circumstances. Lawyers are not able to advise about financial or taxation matters (your accountant should be your go-to for this), and likewise, your accountant can’t advise you on the legal aspects (that’s where we can jump in to help).

If you would like to have an obligation-free discussion around how we might be able to assist you with your business set-up and structure, please give us a call on 1800 001 339 to make an appointment.

This article is of a general nature and should not be relied upon as legal advice. If you require further information, advice or assistance for your specific circumstances, please contact us.