Your Business Structure

Which structure should you operate your business through?

The choice of structure has significant implications for taxation (income tax, capital gains tax) and personal liability – this is an important decision and you should discuss your preferred option with your accountant before proceeding.

The most commonly used structures are:

Sole Trader This is where you operate under your own name, or a business name that you have registered in your name.

Advantages Very simple, low cost structure

Quick to establish and to wind up at the end of the business

Minimal government regulation

Able to offset negative gearing and some business losses against other income

Able to access CGT 50% discount and small business concessions (subject to turnover/asset limits)

Disadvantages Liable to taxation on all of the profits of the business

May be unable to share income with others (see personal services section)

Full personal liability in relation to debts incurred or actions taken against your business

Tax rate on business profits depend on the marginal tax rate of the sole trader – could be up to 46.5%

This structure does not allow the introduction of new investors

Most suitable for small business in low risk industries, with low set up costs and the expectation that the business will not grow much past the activities of the owner. We recommend that no other assets are owned in the name of the sole trader, to minimize risk of loss.

Partnership This is where two or more people or entities join together to own and/or operate the business.

A partnership is defined as an association of persons acting together with a view to profit. This can be contrasted with a joint venture arrangement, where product, not profit, is shared.

We recommend a partnership agreement that specifies certain things, for example how money is invested, how profits are distributed, how business decisions are made, what happens in the event of death of one of the parties, how new partners are admitted etc.

A partnership can be an association of individuals, or an association of entities (companies, trusts), or a combination of both.

For tax purposes, a partner is deemed to have an interest in every individual asset of the partnership – changing partners often has CGT implications.

Advantages Relatively simple and low cost to establish

Little government regulation

Ability to access the CGT 50% discount and small business concessions (subject to turnover/asset limits)

Ability to share taxable income between partners in the proportion of partnership holding, and where a taxation loss is incurred, the partners are able to offset this loss against other income that the partner's earn .

The applicable tax rate will be based on the marginal rate of the partner – ability to limit taxation where corporate and some trust structures are utilized

Disadvantages Each partner is liable for the actions of the other partners when representing the partnership – this could lead to one partner incurring trade or other debts that all partners will be liable for

Full personal liability for the individual partners in relation to the debts incurred by the partnership

Well suited to 'Mum and Dad' ventures where low set up costs and income splitting are important (assuming both parties work in the business) and larger projects where corporate and trust structures come together, pool resources and achieve a greater result than could be achieved individually.

Company A company is a separate legal structure, established under the Corporations Act, where shareholders (the owners of the business) and Directors (the management who operate the business) can play independent roles (as in large, publicly listed companies), or be one and the same people (as in small, closely held companies).

There are many different types of companies, but we will focus here on 'limited liability' companies. Years ago, a company was prized as, being a separate legal entity, it afforded a level of protection to the Directors in relation to actions taken against the company. This has been significantly eroded by decisions of the courts and by the actions taken by banks and trade creditors, who generally bind the directors personally in relation to debts incurred by the company. While the shareholders exposure is limited to the unpaid value of the shares that they have been issued, a director's liability is significant and the decision to accept this role should not be taken lightly.

While a company is a simple and well recognised way for your business to present itself to the world, it is often not an ideal structure for the purchase of 'passive' assets, such as real estate and shares, as the 50% general CGT discount is not available to companies. Also, where you have your 'risky' business asset operating through a company, you would not normally purchase and hold your 'safe' passive assets, such as land and buildings, in the same structure.

Advantages Flexibility of entry and exit of owners and managers

Ability to pay wages to owners

Limit to 30% taxation for the company

Some protection in relation to insolvency

Ability to access small business concessions (subject to turnover/asset limits)

Disadvantages Greater complexity and government regulation

Personal liability of the Director in relation to some tax and withholding obligations

50% general Capital Gains Tax Discount is not available (see CGT section for more information) although the disposal of the shares, rather than the business, may qualify for the 50% general discount.

Annual ASIC fees as well as higher accounting fees than under a sole trader structure

A company is suited to businesses that intend to grow (and may need to bring in other investors), are profitable in excess of the remuneration paid to the owners (so that tax is limited to 30% on the excess) and who want to present to the world a professional image.

Trusts There are a number of different types of trusts, but we will focus today on two most commonly used – Discretionary trusts (often known as family trusts) and Fixed, or Unit trusts. There is another form of trusts known as 'Hybrid' trusts that have some fixed and some discretionary features, which are discussed at the end of this section.

A trust is created where a settlor 'settles' the trust (usually today by providing the $10 to open the trust's bank account) and creates an obligation for the trustee to manage the affairs of the trust on behalf of the beneficiaries. There is also an Appointor (or Principal) who has the ability to remove the trustee. The settlor should not have any entitlement to the trust estate, and can never be a member of the beneficiary pool. So you can see, there are a number of players in a trust, but the same people can fill a number of roles.

Commonly, the trust will have a company as trustee, to put another layer of protection between the individuals who control the trust and the business of the trust itself, but this is not essential – individuals can be the trustees of the trust.

The Appointor or Principal is a very important role, as they have the ability to remove the trustee – you would not entrust this position to someone you did not trust. Often there will be two appointors, and processes in place in the event of disputes. It is also essential for the appointors to nominate in their will's who will be their successor in this role.

Discretionary Trust

A Discretionary trust is where, each year, the trustee has the discretion to choose who receives the net income and capital distributions of the trust. This can be contrasted to a Fixed or Unit Trust, where the share of net income received by a beneficiary is determined by the number of units they hold.

Advantages Flexibility - ability to share income among family members, although children under 18 are penalized where they receive 'unearned income', such as trust distributions, interest, dividends etc, in excess of $1,650 per annum

Ability to access the 50% CGT general discount and CGT small business concessions (subject to turnover/asset limits)

Some ability, where contained in the trust deed, to stream different types of income and capital to different beneficiaries

Disadvantages Generally, a more complex entity, not well understood outside the accounting and legal professions

More costly to establish, especially where a corporate trustee is involved

Usually higher accounting fees than under a sole trade or partnership structure

Personal liability similar to that of a company

Losses cannot be distributed to beneficiaries – they are trapped in the trust until it makes sufficient income to use the losses

Usually operate for a term of 80 years and then must be wound up

Difficult to bring in other investors or distribute to members outside the family

A Discretionary trust is best suited to family businesses, where you can identify suitable family members on low incomes that may act as beneficiaries.

Fixed or Unit Trust

Advantages Fixed entitlement of net income

Ability to share income where units in the unit trust are held by a discretionary trust

Ability to access the 50% CGT general discount and CGT small business concessions (subject to turnover/asset limits)

Simple to bring in more investors by issuing more units, although there are taxation value shifting rules that may impose a tax liability on this.

Disadvantages More costly to establish, especially where a corporate trustee is involved

Usually higher accounting fees than under a sole trade or partnership structure

Losses cannot be distributed to beneficiaries – they are trapped in the trust until it makes sufficient income to use the losses

Personal liability similar to that of a company

Usually operate for a term of 80 years and then must be wound up

Best suited to business ventures with non related parties, where the units issued may relate to the value of property/assets contributed to the venture by each of the participants.

Hybrid Trust

A hybrid trust has a combination of fixed entitlements (or units) and also the ability to distribute to discretionary beneficiaries.

Superannuation Superannuation funds, and we are talking here about self managed superannuation

Funds funds (SMSF), are prohibited from operating a business, but are able to purchase business real property, in their own right or in partnership with another person or entity, with specific restrictions.

The sole purpose of a superannuation fund is to provide benefits to members in the event of their retirement or death.

A significant restriction on superannuation funds is that they have a limited ability to borrow to purchase assets, and the assets that they own are unable to be used as security for any borrowings.

Generally, a superannuation fund is a useful vehicle in which to hold business real property, as the assets of the fund are protected from the creditors of the business (as long as you have not contributed cash or assets to the fund with the intent of defeating your creditors). The value of the member benefits increase from the rental income received from the property, and the fund pays tax at a rate of 15% (or zero when all of the funds assets are supporting pension payments to the members).

You do not take on a self managed superannuation fund lightly – the fund must be audited every year and any contravention identified by the auditor must be referred to the Australian Taxation Office (ATO). The cost of accounts preparation and audit for a simple fund is usually $2,000 per annum or greater, so that you can see that it is wise to have $200,000 or more in superannuation funds available to keep this administration cost to 1% or less.

The fund must also have an investment strategy that needs to be reviewed annually. If you are not going to actively manage the investments of your fund, in conjunction with your financial planner, you may not be suited to having a self managed superannuation fund.

Some Recommended Structures

In the interests of asset protection, we do not recommend that a sole trader or partnership structure be adopted. We understand that clients may still choose to use this structure in extremely limited circumstances, such as:

Low risk activities
Close family only involved
Short term venture
Little/no prospect of growth – only returns a 'wage' to the owners

In the following simple example, we have a business that is operated by a company – the company undertakes no other activity. The choice of Director is guided by the individual who has the least amount of assets, although the individual who presents themselves as the face of the company may, by their actions, be a deemed director. Where you have only one Director, it is essential for the orderly operation of the company that a Power of Attorney be in place in the event of the death of that Director and we recommend at least 2 signatories to the company's bank account so immediate expenses, such as wages, can be paid.

Company A Pty Ltd Dad – Director

Mum and Dad – hold one ordinary share each

Where you intend to operate a business and purchase rental property, you may choose to operate through a number of discretionary trust structures. We recommend that you do not mix ‘risky’ business assets with ‘passive’ real estate assets in the same trust.

Company A as trustee for	Company B as trustee for
|	|
The A Family Business Trust	The A Family Property Trust

This structure can be very useful where the two trusts are ‘family trusts’, part of the same family group, the business is making excess profits and the property is negatively geared. The A Family Business Trust can make a distribution at the end of the year (or on a monthly basis, if required to make up the shortfall in (ideally, interest only) loan repayments) to the A Family Property Trust, which will have the effect of absorbing the Property Trust’s losses, and reduce the amount of tax payable by the group, while ensuring the business and property are protected from the activities of the other, and from any potential liability from the individual owners. Where multiple properties are owned, it is often recommended that a separate trust be established to hold each property, to ensure that they are protected from any action commenced in relation to any individual property.