Accounting Services Australia

Guide to Business Structures

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Guide to Business Structures

Choosing the correct business structure is a complex area. To help you understand the main structures available, we have produced the following guide. There are many issues to consider, and professional advice should be obtained to ensure that you setup the best structure for your situation. Getting the correct structure in place before you commence your business can avoid the need for a costly restructure down the track.

There are three main areas to focus on when analysing the business structures:

Taxation effectiveness

- Keeping the tax expense down and staying within the current rules.

Asset protection

- Protecting your personal and business assets as much as possible from creditors and other claims in the event that things do not go well.

Business efficiency

- You will need to operate efficiently in your day to day transactions while providing the security your venture requires.

There are five main structures used to operate a small business:

Sole trader

Partnership

Company

Discretionary Trust

Unit Trust

The type of business structure you choose will affect your taxation position, your personal legal liability, the life of your business, and the availability of capital to establish and operate your business.

Personal Services Income (PSI)

Before we consider the business structures, you need to consider whether your business provides personal services. If the income generated from the business is mainly a reward for your personal skills or effort, then the income will be PSI.

PSI can apply to almost any industry, however common examples of PSI businesses include doctors, lawyers, engineers, architects, consultants and construction workers.

If the income received is PSI, then special tax rules apply so that you are personally taxed on the income, rather than having it taxed in the entity.

While this limits the tax benefits available through a company or trust, you may still need to setup an entity to trade with certain organisations. Often a business will not engage you as a sole trader as they would have a risk of having to pay PAYG Withholding tax and superannuation.

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Sole trader

A sole trader business is the cheapest and easiest to setup, but gives you the least protection and flexibility. The individual will be required to declare the business income on their personal tax return, and there is limited opportunity to split income to other family members.

A sole trader will pay tax at 32% once their income is above $45,000, compared to the small business company rate of 25%. The individual tax rate is then 47% for income above $190,000. The high level of personal tax rates can limit the sole trader's ability to re-invest into the business for growth as more profits are taken in tax.

As a sole trader, you will be personally responsible for any business debt or loss. Creditors are able to make claims against your personal assets – including your home to enforce payment of your business debts.

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 in a will.

Partnership

A partnership can be used where two or more people wish to operate a business together, however a partnership is not a separate legal entity. A partnership agreement should be prepared particularly when the partners are not related.

One of the advantages of a partnership is the possibility of income distribution. Husband and wife partnerships are therefore common; however the ability to distribute the income equally between the partners is not automatic, particularly because of the PSI rules described previously. Please ask for specific advice.

In a partnership, partners pay tax at the ordinary individual rate on their partnership income.

The members of the partnership are personally liable for all partnership debts. Since partners are legal agents for each other, it is important to choose your partner or partners carefully. There is a presumption that partners will be jointly liable for contracts made by any one partner and that they will be jointly and severally liable for claims against any of the other partners in relation to the business.

The administration cost of a partnership can be high when admitting new partners or removing a partner. Some states (such as Queensland) charge transfer duty on the transfer of a partnership interest, and the partnership will generally require a new ABN and tax registrations. The partnership will automatically cease on the death or bankruptcy of a partner, unless there is a written partnership agreement in place.

Company

A company is a legal entity that is separate from the people who own it. A company is owned by its shareholders and controlled by its Directors, who may be (but do not need to be) the same people.

A company is taxed separately from its owners at the company rate of tax (usually 25% for small businesses). Company profits paid to the shareholders as dividends are taxed under the dividend imputation system. Tax paid by the company is added to the income of the shareholder, who then gets a tax credit for the tax amount. If the individual's tax rate is lower than the company rate, then they can receive a refund of any excess tax included in the dividend.

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Over the long term, the company's profits will be taxed at the rates applicable to the individual shareholders. The advantage of a company is that tax is limited to 25% on profits retained in the company, such as to fund working capital and expansion of the business. Further, in high income years the company can retain income and defer the payment of dividends, thereby also deferring tax. There can be permanent tax savings from paying dividends in years when the shareholders have lower personal incomes. Note that strict tax rules limit the ability of the individuals to use the retained earnings in the intervening period.

Another important advantage of a company is greater access to tax deductions for superannuation contributions, for family members employed in the business.

Company Directors have many statutory obligations and various common law duties and responsibilities. All companies are governed by the Corporations Law. It is from this that Directors derive these powers, obligations and duties. They must act honestly and in good faith for the benefit of all the shareholders and 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.

In general, the shareholders of a company are only liable for the company's debts to the amount unpaid on their shares, or to the amount of any personal guarantee given by them. The Directors can however, be personally liable for the debts of the company if the Directors continue to trade, if they know that the company cannot pay its debts. Directors can also be made liable for unpaid employment obligations, such as PAYG Withholding or superannuation.

A company's business can continue after the death of its owners. The shares become part of the deceased estate, and are dealt with under the will in the same way as other assets. The company can continue to trade unhindered. A company ends by a process called liquidation, under which the remaining assets are distributed among the shareholders in an orderly manner. In simple cases the company can just be struck off the register.

Companies are well established as business structures, which means that banks are generally comfortable lending for a business operated by a company. The banks typically require personal guarantees and/or mortgages over personal assets as security for loans.

A company is an effective structure if you have (or plan to have) un-related owners, as the rights are fixed based on the shares issued. It is also easier to admit new owners, as the business can continue in the company, and there is generally no transfer duty on shares.

Discretionary Trust

Discretionary trusts are popular as a form of business structure because they are a flexible means of distributing income and assets between family members (called beneficiaries), while allowing the business person to retain control over the business assets.

Day to day management of a trust rests with the Trustee(s), who can be one or more individuals, or a company. The Trustee(s) must operate the trust in accordance with a legal document called the trust deed, which gives the Trustee(s) wide discretionary powers to distribute income and assets among the beneficiaries, and the power to carry on the business. Ultimate control is held by a person (or group of people) called the Appointor(s), who can appoint or dismiss the Trustee.

Trusts provide income tax savings by allowing income to be spread among the beneficiaries. Limited amounts of income can be distributed to children under 18 tax-free, which is generally not possible with other entity types. Particular types of income, such as capital gains or franked dividends, can be directed to individual beneficiaries to best suit their individual tax position.

All of the income of a trust must be distributed to the beneficiaries each year. A trust cannot retain earnings in the way that a company does (as the highest tax rate would apply to that income). This

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can be overcome to some extent by including a company among the beneficiaries, but complex tax rules may limit the effectiveness of that structure.

A trust provides the same advantage as a company regarding access to deductions for superannuation contributions, for family members employed in the business.

If the Trustee is a company, a trust provides the same asset protection and ongoing existence as a company. If the Trustee(s) are one or more individuals, the Trustee(s) are personally liable for all debts of the trust and must be formally replaced upon their death.

Discretionary trusts are generally only used for a particular family group, and if there are un-related parties, it is often necessary to have two or more trusts (in partnership), or to use a fixed structure such as a company or unit trust.

Unit Trust

A unit trust is a particular type of trust, where the ownership of the business is divided between the beneficiaries based on a number of units. It lacks the flexibility of a discretionary trust, but allows for fixed proportions of ownership while retaining the other attributes of a trust structure as described above.

Unit trusts and companies are the most common structures where unrelated parties jointly purchase a business.

Other comments

The choice of the correct business structure can be of critical importance to the success or failure of the business. It is also wise to seek advice as to the relative initial cost and ongoing costs of each structure, whether you will have a need for limited liability, how your choice of structure will affect the availability of finance, and whether there is any specific legislation relating to the type of business you intend to operate.

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Which Business Structure?

Structure	Advantages	Disadvantages
Sole Trader	Low costs of entry Easy to set up No big legal costs No separate tax return required No business name registration required (if using your own name)	Personal liability for all debts When you die, the business dies
Partnership	Partnership itself does not pay tax Relatively inexpensive to set up and run although a Partnership Agreement is strongly recommended Possible ability to distribute income between partners	Personal liability for all debts Liability incurred by one partner passed onto all partners Potential relationship problems
Company	Limited liability Company tax rate is usually lower than the personal rates	More expensive to set up and run than a partnership Separate tax return and company accounts required Knowledge of director's responsibilities required
Trust	Income sharing with family (although there are limitations with respect to personal services income)	Personal liability for all debts (unless setup with a trustee company) More expensive to set up and run than a partnership Separate tax return and accounts required

The above information is intended as a guide only and should not be a substitute for legal advice.

The choice of structure is an important one and may involve multiple entities to achieve all the objectives required – tax effectiveness, wealth creation and asset protection.

Tax rates are applicable for the financial year as indicated in the report as legislated at date of publication. Tax rates are subject to change by the Government.

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