BUSINESS & INVESTMENT STRUCTURES

The choice of an appropriate business or investment structure is very important in order to maximise your returns and at the same time minimise the legal and economic risks as the owner.

Changing structures has serious tax and legal implications so it is important to make the right decision at the onset to avoid the need to change the structure at a later stage.

Although tax should not be the single most important factor in deciding on the most appropriate structure, different structures have different tax implications.

Trading Structures

There are four common trading structures that people can choose from that are appropriate for small and medium businesses:
1. sole trader;
2. partnership;
3. company; and
4. trust.

The type of structure chosen will be influenced by various factors. Whilst tax related considerations are important there are many other issues requiring careful consideration. The following non-exhaustive lists outline some tax related and some non-tax related factors that may be relevant:

Non-tax related considerations

- exposure to liability/asset protection;
- level of control;
- general wealth creation;
- financing alternatives;
- disclosure of results;
- annual compliance costs/level of reporting;
- exposure to family disharmony;
- employee v proprietor
- succession planning;
- estate planning; and
- ability to restructure.

Tax related considerations

- immediate & ultimate effective rates of tax;
- the tax base (what income and gains are included; what deductions/losses are allowed);
- access to concessions;
- income diversion & accumulation;
- level where tax losses may be utilised & ability to carry forward losses;
- deductibility of financing costs;
- cash flow
- private v business expenditure;
- effect on social security entitlements;
- personal exertion rules;
- ability to maximise superannuation contributions; and
- potential anti-avoidance issues.

The importance of the various considerations differs depending on your circumstances. There is therefore no such thing as a universal structure — only one that is more suitable to your individual circumstances.

To ascertain which is best suited to your business, you need to familiarise yourself with the advantages and disadvantages of the most common forms of available business and investment structures.

Advantages and Disadvantages of the Various Trading Structures

Sole trader/individual

As a Trading or Business Entity:

A sole trader is an individual who operates a business in their own right. The individual is a distinct legal entity and the business is not a separate entity from the owner.

There is no statutory regulation of a sole trader apart from having to register the business name should you chose to trade or advertise a name other than your own personal name.

<u>Advantages</u>

- It is the least expensive structure and relatively easy to set-up;
- There are minimal annual compliance costs and no specific legislation that regulates sole traders;
- The accounting systems and reports may be relatively uncomplicated;
- You will have full control over the operations of the business, as decision making is the responsibility of one person;
- Subject to qualifying conditions, the structure qualifies for capital gains concessions available to individuals (e.g. discounted capital gains and CGT rollover relief); and
- All profits go to the single owner.

Disadvantages

- There is unlimited liability. Creditors will have a right of claim against both the owner's business and personal assets (including the family house);
- The owner could incur liability for civil damages related to the actions of employees whilst they are performing their work related duties;
- The business may cease on the death of the owner. It is not uncommon for the deceased's will to create a testamentary trust on death and to thereby provide for the continuity of the business;
- The owner cannot sell their interest without selling the business itself;
- Profits are subject to the owner's marginal tax rate with no flexibility for retention of profits within the business.
- There is no potential for splitting income.

Direct Ownership of Investment Assets:

Advantages

- the individual will be subject to tax on their investment income at their personal marginal rate;
- income and gains from investments may be grouped and offset against losses from other activities (but capital losses may not be offset against revenue income, even at the individual level);
- revenue and capital losses may be carried forward indefinitely, without the need to satisfy any additional tests; and
- the individual will qualify for the ``50% CGT discount'' on capital gains made on investments held for more than 12 months.

The CGT small business concessions are generally not relevant as these concessions only apply to ``active assets'' used in a business and it is unlikely that passive investment assets will ever qualify as "active assets"

Disadvantages

- almost complete lack of ``asset protection'' for that accumulated investment wealth — those assets are directly exposed;
- where the individual personally carries on activities that carry a high degree of inherent risk, such as medical, accounting or legal professionals or directors of companies, exposing the individual's investment wealth to those risks is simply not acceptable; and
- any income and capital growth associated with the investments accrues solely to the benefit of that individual.

Partnership

At common law a partnership exists when two or more persons or entities enter into a business with the view of making a profit. Taxation legislation defines a partnership more widely as "an association of persons carrying on business as partners or in receipt of income jointly, but does not include a company".

A partnership is not a separate legal entity from the partners. The partners are the legal entity and are responsible in their own right. Each partner is taxed at their marginal rate on their share of the income or loss of the partnership. Partnership income retains its character in the hands of the partnership.

Although the partnership is not liable to tax it is still required to lodge an income tax return.

A written agreement is not legally required however it is advisable to have one written up otherwise the provisions of the various State Partnership Acts will apply.

Some of the things a partnership agreement should provide for are:

- the date the partnership comes into existence;
- the capital contributed by each partner;
- how the earnings and assets are to be distributed amongst the partners;
- the limitations of authority of any partner;
- how the partnership can be dissolved;
- how disputes between partners are resolved; and
- how new partners are admitted and the process for the retirement of existing partners.

As a Business Structure:

Advantages

- a partnership is not expensive to set-up;
- other partners can provide an additional source of funds for the business. This may be limited if the partner is a member of the same family;
- each partner contributes additional skills to assist in the management and development of the business;
- revenue & capital losses flow through to and can be utilised at the partner level;
- a partnership offers some flexibility to split income between partners;
- as a partnership is not a taxpaying entity, entitlement to the 50% CGT discount is determined on a partner basis (but note that a partner that is a company will not qualify for the discount);
- access to the Small Business CGT Concessions is also determined at a partner level;
- a partnership carrying on trading activities will generally be entitled to a deduction for interest incurred on money borrowed for working capital & other partnership related expenses;
- partners can dispose of their interests in the business;
- new partners can be admitted (however there may be adverse capital gains tax consequences);
- responsibilities can be shared and each partner can act as backup if one partner is sick or wants to take holidays;

Disadvantages

- each partner can bind and obligate all other partners;
- partners are personally liable for all partnership debts;
- there is unlimited liability;
- the Corporations Act imposes a general restriction of no more than 20 persons in a single partnership (except for certain professional partnerships);
- there is no flexibility for retention of profits within the partnership as profits are distributed to each partner and taxed at their marginal tax rates;
- partners may incur liability for civil damages related to the actions of employees whilst they are performing their work related duties;
- there may be disagreements between partners over how the business should be run;
- the partnership may cease on death of a partner; and
- disputes over how responsibilities are shared and personality clashes may occur in a partnership.

As an Investment Vehicle:

A partnership is likely to be appropriate as an investment structure where:

- the acquisition of the property is to be ``negatively geared'' — due to the fact that the deductions incurred with respect to the partnership property may be claimed by the partners at their individual;
- significant capital gains are anticipated, in respect of which the individual partners would qualify for the 50% CGT discount; and
- there is no apparent need for capital raising subsequent to the formation of the partnership.

The CGT small business concessions are generally not relevant as these concessions only apply to ``active assets'' used in a business and it is unlikely that passive investment assets will ever qualify as “active assets”.

Other Partnerships

The preceding discussion is applicable to partnerships generally. Corporate limited partnerships, professional partnerships and joint ventures have specific rules and are beyond the scope of this discussion. Should you require further information in these areas, please contact us.

Company

A company is a separate legal entity from its shareholders who are the owners and comes into existence on the day on which it is incorporated. The act of becoming a company is referred to as incorporation.

The Corporations Law, which is administered by the Australian Securities and Investments Commission (ASIC) provides companies with separate legal personality upon incorporation. This separate legal existence provides companies with the ability to enter into contracts, sue and be sued and so on just like a natural person.

A company requires a minimum of one shareholder and one director. The liability of the shareholders is limited to the amount (if any) unpaid on their shares in the company.

The Company as a Trading Vehicle:

Advantages

- there is limited liability unless the directors have provided personal guarantees in respect of debts of the company;
- personal assets can be protected from creditors as the debts incurred by the company are its own and not of its members;
- on incorporation a company has perpetual existence and is not affected by such things as the death of a member or director;
- the company can retain profits within the business at tax rates lower than the shareholders marginal tax rates;
- shareholders can also be employees of the company and enjoy all the benefits that go with employment;
- changes in ownership do not impact on the continuity of the business as new investors can be admitted by either issuing new shares or purchasing existing shares;
- there is an ability to sell the entire business interests by the transfer of shares;
- CGT rollover relief and small business CGT concessions are available if special conditions are met;
- there is potential for income splitting & wealth creation in other family members;
- higher tax deductible superannuation contributions may be obtained; and
- additional capital and working funds can be accessed by issuing more shares or through borrowed funds from investors or lenders.

Disadvantages

- directors are personally liable for debts which are incurred by a company when there is no reasonable expectation of them being repaid (i.e. insolvent trading);
- there is no CGT 50% discounting of gains;
- a company is expensive to set up;
- the cost to administer and comply with all the legal formalities is more onerous than for other structures;
- companies are subject to more government regulations than other business structures. control of the business is in the hands of the directors;
- employee on-costs (e.g. payroll tax; statutory superannuation liabilities; fringe benefits tax);
- tax concessions may be „clawed back" when distributed to shareholders;
- Personal Services Income (PSI) rules may limit effectiveness;
- some professional bodies prohibit or severely restrict carrying on a profession via a company;
- complicated rules are involved to carry forward losses for deduction in future years; and
- CGT Small Business Concessions are available but access may be difficult.

The Company as an Investment Vehicle:

As a company is not entitled to the 50% CGT discount on the disposal of capital gains it is generally not an appropriate structure through which to make investments in assets that are expected to appreciate in value.

However, for investments that are expected to generate a significant income stream, but not appreciate significantly in value, the company may represent an appropriate structure. This is because the income will initially only be subject to the relatively low flat corporate tax rate of 30%.

The CGT small business concessions generally will have no impact on the choice of a pure investment vehicle, as unlikely that the assets will qualify as ``active assets'' for these purposes.

Trusts

A trust is an obligation enforceable in court, which rests on a person (the trustee) as owner of some specific property to deal with that property for the benefit of another person or persons (the beneficiary).

For a trust to exist there must be four elements:

1. trust property;
2. a trustee;
3. beneficiaries; and
4. obligations annexed to the trust property.

In general law, a trust is not recognised as a separate legal entity. However, for tax purposes a trust is recognised as such.

The trust deed sets out the obligations imposed on the trustee and the relationship between the trustee, the beneficiaries and the trust property.

A trust deed is normally drawn up by a solicitor and includes amongst other matters:

- the date of establishment;
- identifies who are the beneficiaries;
- names the trustee;
- identifies the powers of the trustee; and
- identifies how distributions are to be made.

The trustee (who may also be a beneficiary, but not the sole beneficiary) has a fiduciary duty and duty of care to the beneficiaries to exercise due care and skill in the exercise of decisions over the trust property.

Each beneficiary (except for a minor and others who are under a legal disability) is taxed on their entitlement to the net income of the trust including capital gains.

To limit the liability of the trustee, who is personally responsible for the debts of the trust, it is common to have a company as trustee. A typical arrangement is where the trust operates the business and a trustee company controlled by the owners acts as the trustee.

Trusts include discretionary trusts (non-fixed trusts), unit trusts and fixed trusts etc.

Discretionary trusts (also known as family trusts) are the most common form of trust and allow the trustee the discretion to distribute to selected beneficiaries the income and capital of the trust.

In contrast, distribution of income and capital for a unit trust is in accordance with the number of units held.

<u>Advantages</u>

(Note, most advantages listed rely on a correctly drafted Trust Deed)

- potential for income splitting by varying the distributions to beneficiaries from year to year;
- ability to attribute different income classes to distributions to beneficiaries;
- an ability to distinguish between income & capital beneficiaries enabling the distribution of capital gains to low-taxed beneficiaries;
- generally, the 50% CGT Discount can be applied at the trust level & will flow through to beneficiaries who would have qualified for the discount if the gain was made by the beneficiary directly;
- subject to qualifying criteria a trust is usually able to access the Small Business CGT Concessions;
- holding property in the name of the discretionary trust may provide protection from legal claims;
- assets of the beneficiary are safeguarded against claims made by creditors of the business operated under the trust;
- the ability to consider new beneficiaries; and
- the operations of the business continue on after the death of a beneficiary.

<u>Disadvantages</u>

- trusts are expensive to set-up and maintain;
- the trustee has legal ownership over the property and not the beneficiaries;
- there is a loss of control as the trustee makes decisions;
- the trustee's power is limited to what the trust deed allows;
- in the case of a discretionary trust the indeterminate interests generally make it inappropriate for businesses undertaken by two or more unrelated parties;
- the benefit of franking credits attaching to dividends may be lost to a discretionary trust unless certain elections are made;
- there is a degree of legislative uncertainty surrounding the tax treatment of discretionary trusts & there is a risk that future legislative changes may have adverse consequences for discretionary trusts;

- ability to carry forward losses can be difficult as tax legislation imposes complicated rules and preconditions in this area;
- access to the Small Business CGT Concessions depends on being able to identify a „significant individual‟;
- even if unit trusts are able to access the CGT Concessions distributions of untaxed amounts to unitholders may trigger CGT Event E4 wherein the cost base of the units are reduced or if the cost base is fully eroded, triggering an immediate CGT liability to the unitholders;
- there is no ability to transfer losses to beneficiaries with losses remaining in the trust to be offset against future trust income;

Holding Investments in Trusts:

A trust may be an appropriate entity to hold investments.

- if significant capital gains are anticipated, in respect of which the beneficiaries would qualify for the 50% CGT discount;
- although a unit trust can hold investments, a discounted capital gain on the disposal of those investments may trigger CGT Event E4 with adverse consequences described above; and
- the investment is to be ``negatively geared'' and there is other trust income to offset the investment loss otherwise losses are quarantined.

The CGT small business concessions generally will have no impact on the choice of a pure investment vehicle, as unlikely that the assets will qualify as ``active assets'' for these purposes.

Summary

As you can see, there are numerous factors to consider in choosing the most appropriate business structure to pursue. The choice is not an easy decision as it has serious implications. Ultimately the right decision is dependent on the circumstances of the individual/s. For some individuals, asset protection may be an important consideration. For others, it could be making sure that the business assets and the continuity of the business is unaffected by the death of its owner/s or operator/s.

We understand that this is a complex area and are happy to assist you to evaluate your options. Please do not hesitate to contact us regarding any queries that you may have.