Business structures: start with the end in mind

When choosing a suitable business structure to conduct your business, consider what will be the consequences when you decide to sell it and/or retire.

There are a number of legal structures which can be used to carry on your business. They do not all share the same characteristics with respect to liability, asset protection, succession and taxation. One structure may be more favourable to your situation.

Furthermore, with the recent introduction of Workchoices, which only applies to corporations, the law applying to your employees will be determined by the structure you adopt.

Each structure has their advantages and disadvantages so in selecting the best structure it is a matter of weighing up the competing considerations. We can help you make that decision based on our knowledge and experience.

It is essential that careful consideration be given to the legal structure you select **prior to** acquiring or starting up a new business. Changing structures can be expensive and complicated.

The Structures

The business structures which are commonly used to carry on a business are:

1. **Sole trader**: A sole trader is an individual carrying on the business in his or her own name. Upon the death of the sole trader, the business is dealt with according to the will of the deceased sole trader;
2. **Company**: A company is a separate legal entity distinct from its shareholders. Companies are perpetual and do not cease with the death of a shareholder. The assets of the business are owned by the company. The shareholders own shares in the company but do not have a legal interest in the assets of the company. Companies are regulated by the Corporations Law;
3. **Partnership**: a partnership is where two or more persons carry on an enterprise with a view to making and sharing profits. Partnerships are governed by the Partnership Act and the terms of any partnership agreement;
4. **Trust**

   A trust is a legal arrangement whereby the trustee holds the trust property (and runs the business) on trust for the beneficiaries of the trust. A trust is not a separate legal entity.

   - **Discretionary Trust -** A discretionary trust is where the trustee has discretion according to the terms of the trust deed to distribute income and/or capital amongst a class of nominated beneficiaries; and
   - **Unit trust** - A unit trust is where the beneficiaries hold an allocated number of issued units in the trust. Legal title to the trust property is held in the trustee.

The trustee of the trust may be a company or an individual(s). However usually a company operates a business for a trust.

Trusts are regulated by the terms of the trust deed and the general law. The Corporations law does not apply to trusts except to the extent that the trustee may be a corporation.

Liability

Different legal consequences with respect to liability apply to these different types of structures.

1. Sole Trader: the individual sole trader is personally liable for the debts of the business.
2. The shareholders of the company are not personally liable for the debts of the company; the company is liable to creditors to the extent of the value of its assets and share capital.
3. Partners are personally jointly and severally liable for the debts and liabilities of the partnership. Each partner is liable to the creditors for the full amount of the debts.
4. In a trust, the trustee is liable for the debts incurred in respect carrying on the trust business and its liability is not limited to the assets of the trust. However the trustee has a complete right of indemnity against the assets of the trust. The trustee may also have, depending on the terms of the trust deed, a right of indemnity against the beneficiaries. However the beneficiaries are not directly liable to the creditors of the trust.

Tax consequences on disposal

The Discount under Division 115 Income Tax Assessment Act (ITAA)**:**

A 50% discount in respect of capital gains tax is available to certain taxpayers who derive a capital gain from an asset held for more than 12 months (Division 115) .

However the discount does **NOT** apply to companies. It applies only to individuals (including partnerships), and trusts. This is an example of how a decision on the structure of the business needs to be made at the beginning of the business to avail oneself of the tax advantages of particular structures.

The Small Business Concessions:

The 4 concessions on CGT under Division 152 Income Tax Assessment Act (ITAA) are:

1. Any asset held for more than 15 years where the relevant individual is aged 55 or over and retiring, or is permanently incapacitated, is **NOT liable for any capital gains tax** upon disposal;
2. The small business 50% active asset reduction is available for disposal of assets not exceeding $5m ($6m from 2007 year);
3. the small business retirement exemption: a deduction up to $500,000 from the capital gain is available to the retiring taxpayer; and
4. the small business rollover. This provides a deferral of capital gain ir a replacement asset is acquired.

By way of example, a qualifying asset bought for $1m and sold for $2m after 12 months would attract tax on $500,000 and not the full $1m profit.

If the vendor aged 55 or over was selling his business and retiring, no tax would be payable after utilising the 12 month discount, the small business discount and the retirement deduction. If the vendor is under 55 years of age, the amount must be paid into a superannuation (or similar) fund.

The asset must be an “active asset” i.e. an asset used in producing the capital gain. For example goodwill of a business. In contrast, a passive investment property is not an active asset.

There is a deal of detail and complexity in the application of the concessions and we can go through this with you depending on your circumstances.

The information in this article is general only and should not be relied upon without first consulting us.

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