CFO Insight – Fact Sheet

Choosing a Legal Structure

You need sound, accurate advice when it comes to choosing the right legal structure for your business. The decision we help you make will take into account the legal liability you are prepared to accept, access to tax concessions, and the costs and complexity involved in running the structure. There are 5 common legal structures to choose from:

1. sole trader
2. partnership
3. company
4. fixed trust and
5. non-fixed trust.

When do I choose a legal structure?

The simple answer is **before you start operating your business**. Choosing the right legal structure is important from the outset, whether you are starting up a business or purchasing an existing business. There are advantages and disadvantages with each structure, but the final choice will be based on a variety of needs in individual situations.

There also may be a point **during the course of your business** that your existing business structure no longer meets your needs entirely, and you may gain additional advantages by changing to a different structure. We will discuss the pros and cons involved to help you make the right decision. You should also seek additional advice from your solicitor when it comes to choosing a legal structure.

How do I decide?

When helping you decide on the best structure we will discuss with you:

- The **type of business you are in**, or planning to be in
- Your predicted **business and personal income**
- The **value of assets** held by the business
- Who **the owners** are, and their expectations and contributions
- The level of **personal liability you are prepared to accept** in the event of legal action
- The **cost and complexity** of the various structures
- Access to **tax concessions**
- **Capital Gains Tax** (CGT) implications if the business is sold

Below are just some of the advantages and disadvantages of each type. CFO Insight can explain the full range of advantages and disadvantages when it comes time to making your decision.

What is a sole trader?

A sole trader is the simplest of the business structures and can be used when you are the sole owner of the business. It is best used when you don't require a lot of outside capital to purchase or start your business. You may use your personal name as a business name without having to register the name, or you can chose a trading name which will be registered through the Office of Fair Trading.

Advantages

- Inexpensive to establish and run, and you have total control
- Income is assessed at the personal tax rate (an advantage if you are on a low tax rate)
- Business losses can be offset against other personal income
- Losses can be carried forward from one tax year to the next
- Less stringent reporting obligations

Disadvantages

- You are personally liable for all debts, putting your personal property (i.e. house) at risk to payoff creditors
- No income splitting with a partner for tax advantages
- The taxpayer cannot be an employee and therefore cannot salary package
- There may be issues of continuity of business in the event of death or illness

What is a partnership?

Partners are joint owners of a business. There can be 2-20 partners in a business. In all cases it is strongly recommended that a Partnership Agreement be drawn up with your solicitor, even if it is between spouses. The agreement will include how profits will be shared, how losses will be covered, the contribution of capital of each partner, how the responsibility of the business's activities and trading will be divided, and what happens when a partner decides to leave the business. If there is no partnership agreement, then all of these factors will be equally shared among the partners.

Advantages

- Less costly to establish than a company or trust as it's a fairly simple structure
- Income can be split or losses distributed among partners for tax advantage
- Some tax planning possible with the use of "partners' salaries"
- Easy access to small business CGT concessions
- Flexibility and asset protection can be obtained by using trusts as partners

Disadvantages

- The partners are jointly and severally liable - you will be responsible for your partner's actions
- Generally no asset protection is provided
- Income cannot be accumulated and must be assessed at personal tax rates
- Partners can't be employed for salary packaging purposes

What is a company

A company is considered a *separate legal entity* from its owners. Most companies are limited by shares, which limits the liability of the shareholders to the value of their shares.

However, in the case where negligence on behalf of the Directors is proven, then this asset protection does not apply for the Directors. Also, in many cases banks will ask for a personal guarantee against loans and overdrafts, which means again that personal asset protection will not apply if a loan is not repaid as agreed.

Advantages

- There is limited liability for shareholders (unless a personal guarantee is given)
- Companies have perpetual existence
- The company can employ the 'owner' and therefore salary packaging applies
- Flat tax rate of 30%. Profits can be retained in the company and taxed at this rate
- It's easy to admit or retire partners by simply buying or selling shares or issuing new shares

Disadvantages

- They can be complex and costly to set up and run
- Losses cannot be distributed to individuals for tax advantage
- Income and capital cannot be distributed in a flexible way
- Directors can be personally liable for the company's debts in certain circumstances
- 50% CGT discount is not available, as with trusts, partnerships and sole traders
- They are costly to wind up
- Division 7 A applies in respect to loans and other payments to shareholders

What is a trust?

A trust is established through a trust deed and is often used in connection with running a small business. A trustee (usually a company) makes decisions, such as distributing income and borrowing money, on behalf of the trust and is responsible for the financial well-being of the trust. Trusts are not considered a separate legal entity, as companies are.

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There are 2 types of trusts: unit (or fixed) trusts and discretionary (or non-fixed) trusts. The difference relates to the way profits are split among the unit holders or beneficiaries.

Unit trusts

This structure is usually chosen for non-related parties who contribute different amounts to the trust. Each entity holds a number of units in the trust depending on the amount contributed. The distribution of profits from the trust is fixed, based on the number of units held.

Advantages

- Assets are protected through limited liability
- Less regulation than a company
- Salary packaging and employer sponsored superannuation is available to the principals
- The 50% CGT discount is available
- The trust is not taxed as a separate entity

Disadvantages

- Complex trust rules and PA YG calculations for beneficiaries apply
- They are more costly to establish and operate than partnerships
- Losses cannot be transferred or distributed, and are trapped in the trust
- Distribution of tax-free income and gains has CGT implications to the beneficiaries
- Individual trustees can be personally liable for the debts of the trust
- Accumulated income is taxed at the top marginal rate

Discretionary trusts

This structure usually suits trusts established with family members. The main difference is that profits can be split, and the profit split can be changed each year, if necessary.

Advantages

- Ultimate asset protection exists when there is a corporate trustee. Not only are the principal's personal assets protected from creditors of the trust, but the business is protected from the principal's personal creditors
- Flexible distributions allow income splitting
- Tax free distributions can be made to beneficiaries
- The 50% CGT discount is available
- Less regulated than a company
- Income can be distributed to a company, for taxing at the corporate tax rate

Disadvantages

- Complex trust rules apply and they are costly to establish and run
- Individual trustees can be personally liable for the debts of the trust in some instances · accumulated income is taxed at the top marginal rate
- Beneficiaries do not have a transferable interest
- Cannot distribute losses to beneficiaries. Losses are trapped inside the trust.

Our service to you

From the commencement of your business and right through the ownership you will receive specialist advice to help you understand the full implications of your legal structure, as well as how to maximise its benefits.

*If you would like further help on choosing a legal structure, or to simply discuss this fact sheet, please call **Philip Barnes**, Director, CFO Insight on **0405 800 767**.*