Legal/ Tax Structures

Which legal/tax structure should I operate my business through?

All structures have significant disadvantages as well as advantages, so you need to identify what things are most important:

- Asset protection?
- Minimisation of income tax?
- Minimisation of capital gains?
- Simplicity?
- Or something else?

Sole Trader

A sole trader or a sole proprietor is a person who owns and conducts a business enterprise for profit.

A sole trader can trade under his or her name under a registered business name. S/he is solely responsible for all liabilities incurred by the business but benefits from all the profits. Liability is unlimited and therefore includes his/her private assets. It is the simplest form of business entity to start and maintain.

Sole traders pay tax at personal income tax rates and declare income or losses from the business in their taxation returns. Pay As You Go Instalment tax also applies to sole traders.

The advantages of adopting a sole trader structure include:

- Inexpensive to setup and run
- Structure is less complex and easily understood
- Owner has total control and ownership
- Income assessed at own tax rate (advantage if only on a low tax rate)
- Able to obtain 50% CGT discount if asset held for at least 12 months
- Able to obtain the small business CGT concessions easily
  - No controlling individual test (unless asset is shares or units)
  - No requirement to retire when obtaining the retirement exemption; and
  - No ETP group certificate or ETP prepayment statement required
- Losses of a revenue nature are an allowable deduction to the person in the year incurred, subject to the non-commercial loss rules in the Tax Act
- Losses can be easily carried forward
- Easy to restructure to a company using CGT roll over relief
- Taxpayer can borrow money from, and transfer money to, family members without any tax implications
- The business can lend money to family member's interest free.
- Capital loss from the business or investment may be offset against any capital gains

The disadvantages of adopting a sole trader structure include:

- No asset protection so sole trader's personal assets at risk
- Inability to split income to other family members, otherwise than by reasonable salaries
- Income assessed at own tax rate (disadvantage if on a high tax rate)
- Cannot refinance working capital as can for a partnership. Less favorable deductions for superannuation contributions compared with employer sponsored superannuation contributions
- The tax payer cannot be an employee and, therefore, cannot salary package
- There will be tax implications when a partner is admitted
- There may be tax implications when the taxpayer dies or divorces
- Size is limited (i.e. generally suitable for small operations only)

Partnership

A partnership is the relationship existing between two or more persons who join to carry on a trade or business.

Each person (maximum of 20) contributes assets (money, property, labour or skill) to a business with the view of making a profit. They all share the profits and losses of the business in 'agreed ratios' and are similarly liable for all the debts incurred, joint or several. The reason is that each partner is liable for the other partner's actions. In any legal action, a partner can be sued personally.

A partnership is not a taxable entity. Each partner includes his or her share of the income or loss in their personal tax return. Pay As You Go Instalment tax applies to each partner.

The advantages of adopting a partnership structure include:

- Inexpensive to establish and to run, easily understood and more informal than a company or trust
- Can provide some flexibility in the partnership agreement and ability to split income based on level of ownership
- Some tax planning possible with the use of "partners' salaries"
- Partners can obtain 50% CGT discount
- Small business CGT concessions easily obtained
- Partnership losses "distributed" to partners to be offset against other income
- Flexibility for CGT in that each partner can independently choose the concessions they want. Failure by one partner to satisfy the conditions will not affect the other partner.
- Flexibility and asset protection can be obtained by using trusts as partners
- Independent parties can be easily admitted as partners
- Partners/ owners benefits not subject to FBT
- Capital losses may be offset against other capital gains derived by the partners

The disadvantages of adopting a partnership structure include:

- Generally there is no asset protection as each partner is jointly and severally liable in full for the clients of the partnerships as there is no limited liability
- New personal services income laws may attribute all income to one partner for tax purposes

- Income cannot be accumulated and must be assessed at personal tax rates
- Limits in the flexibility in distributing profits
- Partners cannot be employed by the partnership for salary packaging purposes
- Partners cannot claim a deduction for interest on borrowings to pay income tax, whereas, individuals and other business entities can
- Deductions for superannuation contributions are restricted in the same manner as they are for individuals
- The non-commercial loss rules apply

Company

Companies are the principal structure for business entities and are governed by the Corporations Law, which is part of the Corporation Act 2001. Classes of companies include companies limited by shares, companies limited by guarantee, unlimited companies, and no liability companies (used mainly for mining operations).

A company limited by shares is formed on the principal of having the liability of its shareholders limited. Creditors of a company limited by shares have only a limited right to recover from the shareholders in the event of the company being wound up. The liability of the shareholder extends to the unpaid portion of the normal value of the shares: once the shares are fully paid, the holder of them is relieved of liability to contribute on a winding up.

The profit of the company is taxed to both the company at 30% and to the shareholders when the profit is distributed as dividends. Note if tax has been paid this is included with the dividend as an imputation credit.

The advantages of adopting a company structure include:

- The company is a separate legal entity i.e. it can be sued, it can enter into legal contracts
- Asset protection and limited liability. If the company's business fails, the personal assets of the shareholders are protected but personal guarantees may be required
- Continuity of existence
- The company can employ the taxpayer and provide salary packaging
- By employing the taxpayer, the company can provide employer sponsored superannuation and obtain maximum deductions compared to individuals and partnerships.
- It is easy to admit or retire partners by simply buying or selling shares, or alternatively by issuing shares. Ownership changes are easy
- Shareholders have a fixed interest in the company so they can be certain of their entitlements. Franked dividends can be passed to shareholders who can claim a refund of any excess imputation credits
- Profits can be retained and taxed at the corporate tax rate of 30% when personal services income is not involved

The disadvantages of adopting a company structure include:

- Set-up and operating costs are relatively high
- Complex to administer as statutory reporting requirement must be complied with under the Corporations Act
- 50% CGT discount not available.

- Cannot distribute losses to individuals as revenue and capital losses must be retained by the company for recoupment
- Complex rules regarding the carrying forward of losses.
- No easy way for a company to pass tax free amounts to shareholders without them being taxed in the shareholders' hands.
- Division 7A applies in respect of loans and other certain payments to shareholders.
- Income and capital cannot be distributed in a flexible manner. The anti-streaming and franking credit trading rules apply.
- Directors can be personally liable for the company's debts in certain circumstances.
- Controlling individual test in the small business CGT concessions may be difficult to satisfy. It cannot be satisfied where the majority of the shares are not owned by an individual.
- The taxpayer must terminate their employment with the company in order to obtain the small business retirement exemption.
- New PSI rules can deny deductions and attribute income to the taxpayer providing the personal services.
- The general share value shifting rules may apply when issuing shares to associates for below market value consideration.
- A change in share ownership can cause pre-CGT assets to be treated as post-CGT assets.
- A change in asset ownership can cause pre-CGT shares to be subject to CGT on sale.
- Costly to wind up.
- Owner's benefits may be subject to FBT

Trust

A trust is usually set up by an individual (called the settlor) who puts assets into "trust" for the benefit of others who are called the beneficiaries. A trustee is appointed who has control of the assets and manages them. It is set out in the Trust Deed exactly which areas or types of business the trust can be involved in and the extent of the trustee's powers. The trust establishes a business or acquires a business or acquires investments from which it derives an income and this income is then distributed to the beneficiaries.

Both income and capital can be distributed by the trustees. Trusts are used to split and distribute income over a number of people to enable a group to minimise tax by taking advantage of progressive tax rates. The trustee may be personally liable for the debts and actions of the trust and for this reason Trusts are normally set up with a proprietary limited company acting as trustee. This limits the trust liability to the assets of the trust and of the Trustee Company.

Discretionary Trusts

The trustee is able to vary the amount of income distributed to particular beneficiaries from year to year. This is the most widely used type of trust because of its versatility. It is particularly useful in family situations.

The advantages of adopting a discretionary trust structure include:

- Ultimate asset protection when a corporate trustee is used. 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. Unlike a company or unit trust where the shares or units of the principal are assets of the principal which form part of the principal's bankrupt estate

- Less regulation than a company
- Flexibility of distributions of income and capital to beneficiaries
- Income can be distributed to a bucket company to be taxed at the corporate tax rate
- The trust can employ the principals and provide salary packaging and employer sponsored superannuation
- The 50% COT discount is available
- Can still obtain the small business CGT concessions
- Easier to wind up than a company
- Easy to introduce new beneficiaries, provided they are within the range of objects
- Loans can be made to beneficiaries without tax implications. No equivalent to Division 7A
- Easy to wind up
- Control can be easily transferred by changing trustee and/or the appointor
- The general value shifting rules should not apply
- Distributions can retain their character as dividend, interest or capital gains i.e. income streaming

The <u>disadvantages</u> of adopting a discretionary trust structure include:

- Taxpayers often have difficulty understanding the structure and how the concept of a trust works
- Structure is more costly to establish and maintain, particularly where a corporate beneficiary is used and there is a corporate trustee
- Cannot distribute losses to beneficiaries. Losses are trapped in the trust
- Revenue losses may be denied under the trust loss provisions
- May need to elect to be a family trust to satisfy trust loss rules or to be able to distribute franked dividends to beneficiaries without adverse tax implications.
- No perpetual existence, normally must be wound up within 80 years.
- More difficult to satisfy conditions for the small business CGT concessions, in particular the controlling individual test.
- Amendments to the trust deed could constitute a resettlement for CGT and stamp duty purposes.
- If required to make a family trust election, then flexibility of distribution is restricted.
- The trustees can be personally liable for the debts of the trust in some circumstances.
- ATO dislikes trusts, so they are forever being targeted.
- Owners benefits may be subject to FBT

Unit Trusts

Generally used in arm's length dealings instead of private companies. In a Unit Trust, distribution of income is determined by the number of units held.

The <u>advantages</u> of adopting a unit trust structure include:

- Asset protection. Limited liability can be achieved by the use of a corporate trustee with a limited right of indemnity
- Less regulation than a company.
- The trust can employ the principals and provide salary packaging and employer sponsored superannuation
- No need to lodge returns and other forms with ASIC .
- The principals have a fixed interest which is advantageous where independent parties are involved.
- The 50% CGT discount is available.
- The trust is not taxed as a separate entity.
- Loans from the trust are not subject to any special tax rules unless an unpaid present entitlement to a company exists at the time of the loan.
- It is less costly to wind up than a company.
- Easy to admit new partners by issuing units without CGT consequences (but beware general value shifting rules).

The <u>disadvantages</u> of adopting a unit trust structure include:

- Unitholders often have difficulty in understanding the structure and how the concept of a trust operates
- Costly to establish and operate
- A change in unitholding can cause pre-CGT assets to become post-CGT assets.
- A change in asset holding can cause pre-CGT units to be subject to CGT on sale.
- Complex trust loss rules apply. Revenue losses may be denied
- Losses remain in the trust for recoupment
- May need to elect to be a family trust. May not be able to elect to be family trust.
- No perpetual existence, normally must be wound up within 80 years.
- Distribution of tax free income and gains has CGT implications to the beneficiaries.
- Individual trustees can be personally liable for debts of the trust.
- If small business CGT retirement exemption is obtained, the principal must retire as an employee of the trust.
- If units in unit trusts are owned by discretionary trusts, the unit trust will not be able to satisfy the controlling individual test.
- The general value shifting rules may apply when issuing units to associates for below market value consideration.
- Unitholders benefits may be subject to FBT
- Unless the cost base of the units is maintained at the same level as the assets in the trust, indexation and other CGT benefits may be sacrificed