BUSINESS STRUCTURES

Disclaimer

Many of the comments in this publication are general in nature and anyone intending to apply the information to practical circumstances should seek professional advice to independently verify their interpretation and the information's applicability to their particular circumstances.

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There is no one ultimate tax structure that is best for all types of businesses. With so many different tax rules and commercial considerations to take into account, the best tax structure for one business is not necessarily the best tax structure for another business.

If a business is likely to be worth less than $6 million when it is sold then the structure should be one that will allow advantage to be taken of the small business CGT concessions in Division 152. In particular the structure should be one that enables there to be a controlling individual. However, if the net value of the business will be greater than $6 million when sold, this is not a concern, and a different structure can be used.

Often when a business commences, it is hoped that the business will grow but it is unknown as to whether the net value of the assets will be greater than $6 million. Further it is not known when the business will be sold. Sometimes a business may become highly successful quickly and the owner may receive an offer to sell the business which is too good to refuse even though when the business commenced, the intention was to run the business for a long period of time.

In other circumstances, a person may purchase a business expecting it to grow but in fact it may do the opposite. A structure needs to be flexible enough to take into account the unknown.

Another reason why there is no one ultimate structure relates to the possible introduction of partners. If the business is one in which it is intended to introduce third parties as investors or as working partners, then the structure must allow for that in the future, for example a company or a unit trust. On the other hand, if there is no such intention, another structure may be more appropriate, eg a discretionary trust.

Many other factors must be taken into account to determine the optimum structure for the business. Factors such as asset protection and what other assets you own, tax minimisation, retirement plans etc will all affect the structure of your business. A checklist of factors is included in this document for your consideration.

Often people who commence or purchase a business cannot afford an elaborate tax structure. Whilst they believe the business will succeed, they must be careful in their early years to conserve money until the business is up and running profitably. So it is good business practice not to set up an elaborate and expensive structure at the outset. A tax structure should be built over time to allow for your personal financial circumstances and growth in the business. As the business expands, so should the tax structure.

An alternate view to keeping things small and simple is to spend additional funds setting up the structure to potentially save money when the business needs to change its structure due to expansion.

A tax structure may start with a single entity such as a family partnership or trust. Other entities are added as the business grows. For example, a business may start off operating as a sole practitioner. As the business grows you may add a management company for superannuation purposes and a service trust. Investment assets may be held in another trust. So what started as a structure consisting entirely of a person operating in their own name now consists of the individual, a management company, a service trust and an investment trust.

The building process

The building process involves initially establishing the basic structure and then “adding” to it as required. Generally, additions will occur as the business grows and new assets are acquired or as the business changes.

In order to choose the basic structure it is important to consider a number of factors including your circumstances and your plans for the future (both personal and business).

Checklist of factors that should be considered when selecting the basic structure:

1. **Does the principal have a spouse, de-facto partner or children? What are their ages and personal tax rates and the age and personal tax rate of the principal?**

   This is required to determine to whom income can be passed to minimise tax. The older the principal, the more likely it is that superannuation will be an issue. If you want to maximise superannuation contributions, you will need to be an employee of your entity.

2. **What is the current tax status and potential liability status of these immediate family members?**

   For asset protection purposes, individuals who may be sued should not own significant personal assets. They should also not own interests in entities in the structure.

3. **Are there any other people, such as close relatives, who are to be part of the business?**

   There may be parents, cousins etc who may be involved in the business or, who the principal may wish, to benefit from the business. Alternatively there may be someone who is willing to own the assets separately from the principal and the business structure for asset protection purposes.

4. **What assets do you and your family members own?**

   The business structure should protect any assets that you already own from the creditors of the business. So if the business collapses, your personal assets (such as your family home) will not be lost as well. If you own significant assets, the business should be operated through a separate entity.

5. **What debt do you and your family members currently have?**

   If you have significant personal debt, then the business should be protected from that personal debt by being operated through a separate entity.

6. **What type of business is it?**

   Will you be deriving business income or personal services income? If it is personal services income (reward for work done solely by you rather than for example the sale of goods), the new rules in relation to personal services income will apply and you will be unable to split this income in any way. Alternatively if it is genuinely business income that is being derived, the potential for splitting income is much greater.

7. **Will the business have any offshore activities?**

   If so, there may be scope for offshore tax considerations. Since this is expensive, the size of the business and its anticipated profit should be taken into account.

8. **Will the business have significant assets?**

   If the business will have significant assets, then for asset protection purposes, it is best to have the business held by one entity and the business assets held by a separate entity. Personal assets should be held separately from the business entity as well, for the same reason. If the business fails the personal and business assets should be protected.

   The business assets will need to be held in an entity that is connected with the business entity so that they continue to be active assets. If they are not active assets, the small business CGT exemptions will not be available. This is not relevant for depreciable plant and equipment as it will not be subject to CGT on sale. It is relevant for other assets, such as the business premises.

   If the business assets are held in a separate entity, the entity can lease the business assets to the business entity. But be aware of possible application of Part IVA (anti-avoidance provisions).

9. **Who will be the principals in the business?**

   If the business is to be conducted by two or more independent parties, then the range of structures available is limited. The structure must be one in which each party has some sort of fixed interest so that if a dispute arises, it can be easily dismantled without there also being a dispute over each party's share.

   If there are three or more independent parties, then a single entity structure is unlikely to provide a controlling individual to enable the small business CGT concessions to be obtained in the future. If these concessions are important, a multiple entity structure, such as a partnership of discretionary trusts should be considered.

   If the business is to be operated for the benefit of only one family, a greater range of entities are available. A single family discretionary trust may suffice and electing the trust to be a family trust, if required, may not be a major obstacle. Individual family members owning a fixed interest may not be necessary or even desirable.

10. **How is the business to be financed?**

    If you intend to finance the business by way of an interest free loan and you are considering using a discretionary trust, the trust deed should give the trustee power to create and issue units (thereby creating a hybrid trust) so that you can subscribe for units instead of making an interest free loan to overcome the non-commercial loans rule should it ever be reintroduced. Note that from 1 July 2004, such interest free loans are likely to constitute an equity interest under the debt/equity rules.

    Also if the business is financed outside the trust, the deductibility of interest may be an issue.

    If financing is to be by way of equity, an entity will need to be established in which investors can easily purchase a portion – such as units in a trust or shares in a company.

11. **Do you intend to withdraw much money from the business in the early years?**

    If you intend to withdraw money from the business on a regular basis, then the structure will need to accommodate this. This can be done either by payment of a salary, return of capital or by providing a loan. If you intend to borrow money from the entity, there are rules under Division 7A to restrict this in companies and even though there are no such restrictions in a trust, there may be adverse implications if a company is associated with the entity and certain conditions are met.

12. **Will some parties receive an additional distribution of profits or capital?**

    If so, the entity will need to allow for this. Consideration needs to be given to the dividend streaming rules.

13. **Are discretionary distributions of income or capital required?**

    If so, a company will not be appropriate. A trust will provide the greatest flexibility in this area.

14. **Do you have a good understanding of tax structures and tax generally?**

    If you do not have a good understanding of tax structures and tax generally, then a simple structure should be used. Any entity which you do not understand should not even be considered even though it may provide the best tax benefits.

    A tax structure is only effective if it is operated correctly. If you do not understand the structure and do not operate it properly then any benefits may be lost.

    Further, the incorrect operation of a tax structure can lead to significant tax problems.

15. **Do you have the discipline to run a complicated tax structure properly?**

    Not only must you understand how each entity in the structure works, you must also have the discipline to run the structure properly and to treat each entity as a separate entity. You cannot simply treat the entity's bank account as an extension of your own bank account. A more complex structure can be extremely tax effective, however if it is not run properly, or one single mistake is made, significant extra tax could be payable.

16. **If the business is to be operated for the benefit of just one family, who are to be the owners of the business? Must they have an equitable interest in the business?**

    If each owner is to have their own fixed interest in the ownership of the business, a trust with units or a company with shares may be required, or possibly even a partnership. If the owners need only control the business, but need not have a fixed interest in its ownership, then a discretionary trust, with the owners acting as trustees or as directors of the corporate trustee, may also suffice.

17. **Are new partners to be admitted in the future?**

    It is more difficult to admit new partners to a discretionary trust than it is into a new partnership, company or trust with units. Also, some entities, such as a company, can admit a new partner by issuing shares, without triggering a CGT liability.

18. **What is to happen if one of the partners wants to leave the business?**

    Where independent parties are involved, there should be a separate shareholder's or unit holder's agreement that includes a buy out mechanism as well as a restrictive covenant to protect the business.

19. **What is to happen in the event of the death of one of the parties?**

    The shareholder's or unit holder's agreement should stipulate whether the deceased estate must sell the deceased person's interest in the business to the surviving partners. It should specify how the purchase price is to be calculated and funded. An insurance based funding arrangement should be put in place in the formal buy out mechanism.

20. **Must the business structure comply with a professional association or some other body?**

    Some professional associations and governing bodies limit the range of entities that may be used or stipulate which people must hold the shares etc in the entity.

21. **Will the business employ people?**

    Employers are exposed to claims by employees in respect of unfair dismissal, unsafe workplaces, negligence and other types of claims. There is also potential exposure to action being taken by the ATO and relevant state bodies to recover unpaid PAYG Withholding, FBT, GST, Payroll Tax etc. The entity should protect you from these types of actions. Please note that in some circumstances, directors in a company can be held personally liable for the debts of the company.

22. **What type of clients and customers will the business have?**

    If the business is one of provision of professional services, then exposure to a professional negligence suit is much greater. When establishing a structure, the appropriate insurance should be taken out.

    If the business sells or supplies products, then customers may take action in relation to a faulty product. The structure, where possible, should protect your personal assets from such an action.

23. **Does your supplier specify the types of structures that must be used?**

    Many contractors are required by the payer to incorporate so that the payer need not worry about the PAYG and SGC obligations. This may limit the type of entity that can be used. The alienation of personal services income (PSI) has to be considered.

24. **What are your short and long term ambitions?**

    The structure must be flexible enough to take account of these ambitions. If your intention is to establish a business, make it profitable and to sell it as soon as possible, then obtaining the 50% CGT discount and the small business CGT concessions are extremely important. Minimising CGT is the most important factor and the structure must take this into account.

    If you intend to operate the business for a long period of time, then asset protection and minimising tax on the ongoing profits takes greater priority and minimising the CGT on the sale of the business takes less priority. In this case, the structure should be tailored to minimise income tax on an ongoing basis and to minimise the tax on distributions to you.

    If you intend to expand, the structure must allow you to cope with the expansion – either the expansion of the current business or expansion into new businesses.

25. **Is the business expected to make tax losses in the early years?**

    If yes, a trust will need to comply with the trust loss laws and a company with the carry forward loss rules. In the case of a trust, a family trust election will need to be made.

    If it is important that the losses can be offset against other income, the number of structures available will be limited. In this case a sole trader or partnership will be more appropriate, although there are significant disadvantages in relation to asset protection and the non-commercial loss rules must also be considered.

26. **How big is the business, how profitable will it be and how much money does the client have to spend on a tax structure?**

    There is no point spending a lot of money on a complex tax structure comprising a number of entities if the savings at the end of the day do not outweigh the costs involved.

    If the business is likely to be worth more than $6 million when sold then the small business CGT concessions will not be available and the structure need not comply with the requirements of Division 152. If the business is likely to be worth less than $6 million the structure will need to comply with Division 152.

27. **What are your priorities? What are you concerned about?**

    The main concern of people in business is usually asset protection and that is what should be focused upon. You should look at the broader picture, not just the current business activity. What is the risk of you being sued? If it is medium to high then asset protection should be your main priority. As a general rule, tax minimisation should never be your main priority when selecting a business structure.

28. **Who is going to run the structure on a daily basis? Who is going to have control of the structure?**

    The person who runs the structure may well not be the same person that has overall control and ownership. Some business people like to have direct ownership and want to personally own shares and/or units; alternatively you may be happy to simply have control (ie through using a discretionary trust).

Comparison Checklists

Sole Trader

Advantages	Disadvantages
1. Inexpensive to establish and run. 2. Easy to understand. 3. Total control and ownership. 4. Income assessed at your marginal tax rate (only an advantage if on a low tax rate). 5. Able to obtain the 50% CGT discount. 6. Able to obtain the small business CGT concessions easily. 7. Business losses can be offset against other income subject to the non-commercial loss rules. 8. Losses can be easily carried forward. 9. Easy to restructure to a company using CGT roll-over relief. 10. You can borrow money from and transfer money to family members without any tax implications. 11. The business can lend money to family members interest free.	1. No asset protection so sole trader's personal assets are at risk. 2. No income splitting. 3. Income assessed at own tax rate (disadvantage if on a high tax rate). 4. Cannot refinance working capital as you can for a partnership. 5. The substantiation rules for car and travel expenses must be complied with. 6. There will be tax implications if another partner is admitted to the business. 7. There may be tax implications when the taxpayer dies or divorces. 8. Sole Traders cannot claim a deduction for interest on borrowings to pay income tax.

Partnerships

Advantages	Disadvantages
1. Less costly to establish as compared to a trust or company. 2. Inexpensive to run. 3. Easy to understand. 4. Can provide some flexibility in the partnership agreement. 5. Income splitting between partners (assuming PSI rules do not apply). 6. Some tax minimisation possible with the use of “partners’ salaries”. 7. Partners can obtain the 50% CGT discount. 8. Small business CGT concessions easily obtained. 9. Partnership losses “distributed” to partners to offset against other income (if non-commercial loss rules do not apply). 10. Flexibility for CGT in that each partner can independently choose the concessions that they want. The failure of one partner to meet the requirements will not impact upon the other partner. 11. Flexibility and asset protection can only be obtained by using trusts as partners. 12. Independent parties can easily be admitted as partners. 13. Trading stock and depreciable asset roll-over relief available on the admission of partners. 14. Tax minimisation opportunity available in respect of the refinancing of the partners’ capital accounts by borrowed funds.	1. The partners are jointly and severally liable. 2. Generally no asset protection. 3. New personal services income laws may well attribute all income to one partner for tax purposes. 4. Income cannot be accumulated and must be assessed at personal tax rates. 5. Complex PAYG Instalment calculations (if calculation method is chosen). 6. Partners cannot claim input tax credits if paying partnership expenses. 7. Partners cannot be employed by the partnership for salary packaging purposes. 8. Partners cannot claim a deduction for interest on borrowings to pay income tax. 9. The non-commercial loss rules apply. 10. The substantiation rules apply to car and travel expenses.

Company

Advantages	Disadvantages
1. The company is a separate legal entity. 2. Asset protection. If the company's business fails, the personal assets of the shareholder are protected. 3. Although companies are more complex structures, generally people seem to understand how they operate. 4. Losses can be transferred within the consolidated group. 5. Perpetual existence. 6. The company can employ you and provide salary packaging arrangements. 7. By employing you, the company can provide employer sponsored superannuation and obtain maximum deductions as compared to sole traders and partnerships. 8. It is easy to admit and retire partners by selling or issuing shares. 9. 30% flat rate of tax 10. Shareholders have a fixed interest so they can be certain of their entitlements. 11. Franked dividends can be paid to shareholders who can claim a refund of any excess imputation credits. 12. Deduction may be claimed for interest on borrowings to pay tax or refinancing shareholder's loans or equity. 13. The substantiation rules do not apply.	1. Complex to administer. 2. Regulated by complex Corporations Act. 3. Costly to establish. 4. Costly to run. 5. 50% CGT discount is not available. 6. Cannot distribute losses to individuals. 7. Complex rules regarding the carrying forward of losses. 8. No easy way for a company to pass tax free amounts to shareholders without them being taxed in the shareholder's hands. 9. Division 7A applies in respect of loans and other certain payments to shareholders. 10. Income and capital cannot be distributed in a flexible manner. The anti-streaming and franking credit trading rules apply. 11. Supplies to associates for below market value can be subject to GST. 12. Directors can be personally liable for the company's debt in certain circumstances. 13. 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. 14. The taxpayer must terminate their employment with the company in order to obtain the small business retirement exemption. 15. New PSI rules can deny deductions and attribute income to the taxpayer providing the personal services. 16. The general share value shifting rules may apply when issuing shares to associates for below market value consideration. 17. A change in share ownership can cause pre CGT assets to be treated as post CGT assets. 18. A change in asset ownership can cause pre CGT shares to be subject to CGT on sale. 19. Costly to wind up.

Unit Trusts

Advantages	Disadvantages
1. Asset protection. 2. Less regulation than a company. 3. The trust can employ you and therefore provide salary packaging benefits. 4. The trust obtains the employer sponsored superannuation benefits. 5. No need to lodge returns and other forms with ASIC. 6. There is a fixed interest entitlement. 7. The 50% CGT discount is available. 8. The trust is not taxed as a separate entity. 9. 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. 10. It is less costly to wind up than a company. 11. Easy to admit new partners by issuing units without CGT consequences (so long as the general value shifting rules are not breached). 12. The substantiation rules do not apply.	1. Less people understand how they operate. 2. Ultimate beneficiary statement rules apply. 3. Complex PAYG instalment calculations. 4. More costly to establish and operate than a partnership of individuals. 5. A change in the unit holding can cause pre CGT assets to become post CGT assets. 6. A change in asset holding can cause pre CGT units to be subject to CGT on sale. 7. Complex trust loss rules apply. 8. Cannot transfer losses unless comply with complex consolidation laws. 9. Cannot distribute losses to beneficiaries. 10. May need to elect to be a family trust. May not be able to elect to be a family trust. 11. No perpetual existence, normally must be wound up within 80 years. 12. Distribution of tax free income and gains has CGT implications to the beneficiaries. 13. Individual trustees can be personally liable for debts of trust. 14. Accumulated income taxed at top marginal rate. 15. If small business retirement exemption is obtained, you must retire as an employee of the trust. 16. If the trust is funded by debt (rather than equity) the units or interest owned by the beneficiaries will have a low cost base and this will cause problems where non-assessable amounts are distributed. 17. If units in the unit trust are owned by discretionary trusts, the unit trust will not be able to satisfy the controlling individual test. 18. The general value shifting rules may apply when issuing units to associates for below market value consideration.

Discretionary Trusts

Advantages	Disadvantages
1. Ultimate asset protection where there is a corporate trustee. Not only are your personal assets protected from creditors of the trust, but the business is protected from your personal creditors.	1. They are complex and not many people understand precisely how they work.
2. Less regulation than a company.	2. Costly to establish.
3. Flexible distributions allow income splitting.	3. Costly to run.
4. Income can be distributed to a bucket company to be taxed at the corporate tax rate.	4. Ultimate beneficiary statement rules apply.
5. The trust deed can allow flexible distributions of capital.	5. Beneficiaries subject to complex PAYG instalment calculations.
6. The trust can employ you and provide salary packaging.	6. Cannot distribute losses to beneficiaries. Losses are trapped in trust.
7. The trust can obtain employer sponsored superannuation benefits.	7. Complex trust loss rules apply.
8. The trustee can vary distributions among family members according to their needs.	8. Cannot transfer losses to another trust unless comply with complex and restrictive consolidation rules.
9. The trust deed can be tailored to meet your needs.	9. 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.
10. No need to lodge returns and other forms with ASIC.	10. No perpetual existence, normally must be wound up within 80 years.
11. The 50% CGT discount is available.	11. More difficult to satisfy conditions for the small business CGT concession, in particular the controlling individual test.
12. Can still obtain the small business CGT concessions.	12. Technically very difficult to satisfy the $6 million asset test in the small business CGT concessions.
13. Easier to wind up than a company.	13. Amendments to the trust deed could constitute a resettlement for CGT and stamp duty purposes.
14. The substantiation rules do not apply.	14. If required to make a family trust election, then flexibility of distribution is restricted.
15. Easy to introduce new beneficiaries, provided they are within a range of objects.	15. The trustees can be personally liable for the debts of the trust in some circumstances.
16. Able to stream income to minimise tax.	16. ATO dislikes trusts, so they are forever being targeted.
17. Loans can be made to beneficiaries without tax implications. No equivalent Division 7A.	17. Beneficiaries do not have a transferable interest.
18. Generally tax free distributions can be made to beneficiaries without S104-70 applying.	18. If a new partner is to be admitted to the business, it is not easy to give them a fixed interest.
19. Control can be easily transferred by changing trustee and/or appointor.	19. Additional stamp duty and land tax implications depending upon the state.
20. The general value shifting rules should not apply.	20. Income accumulated in the trust is taxed at the top marginal rate.
	21. It is difficult for a beneficiary of a discretionary trust (that is not a family trust) to satisfy the 45 day holding period rule where the trust receives a franked dividend.

Comparison of different tax structures

	Sole Trader	Partnership	Company	Unit Trust	Discretionary Trust
Separate Entity	N/A	No	Yes	No	No
Establishment Documentation	None	Partnership agreement	Constitution	Trust Deed	Trust Deed
Establishment Cost	Low	Medium	High	High	High
Limited Liability	No	No	Yes	Can be if trustee company	Can be if trustee company
Complexity	Simple	Simple	Complex	Complex	Complex
Distribution of Losses	Individual can use	Partners can use	Trapped in Company	Trapped in Trust	Trapped in Trust
Carry Forward Losses	No restrictions	No restrictions	Continuity of ownership and same business test restrictions	Compliance with trust loss rules	Compliance with trust loss rules
Income Splitting	No	Limited	Salaries or dividends but PSI rules may apply	Salaries or dividends but PSI rules may apply	Salaries or dividends but PSI rules may apply
Streaming of income	No	No	No	Yes	Yes
Interest deduction on return of capital	N/A	Yes	Yes	Yes	Yes
50% CGT discount	Yes	Yes	No	Yes	Yes
Can principal be employed?	No	No	Yes	Yes	Yes
Superannuation contributions	Self employed	Self employed	Employer sponsored	Employer Sponsored	Employer Sponsored
Who registers for GST?	Individuals	Partnership	Company	Trust	Trust
Who pays tax?	Individual	Partners	Company	Beneficiary /Trustee	Beneficiary/Trustee
Do principals have fixed interest	Yes	Yes	Yes	Yes	No (in most cases)
Flexibility	Inflexible	Some flexibility	Inflexible	Some flexibility	Flexible