Information Sheet on Business Structures

This is an education/ information sheet only. We strongly recommend obtaining legal and accounting/ tax advice before any business structure is established, either when commencing business or when restructuring your business.

This information sheet is to assist you in understanding the process of choosing a business structure, which should assist your business advisor in ensuring the right business structure is chosen at the time.

Business Structures should be also be reviewed on a regular basis, as your level of risk changes as your business grows, and also when your personal assets increase in value. Since 1 July 2015, it is significantly easier to change structures without incurring capital gains tax liabilities on the restructure.

We will give you examples of how certain structures were best for a client at particular stages of their business and/or personal life cycle. But, remember everyone's circumstances are different and your advisor should be attempting to match your circumstances to the best structure for you.

We will not cover all aspects that a Business Advisor takes into account when recommending a business structure. This is beyond the scope of this information sheet. Some of these factors include capital gains tax implications of when you may sell the business and whether you want to have profit sharing arrangements with your key employees. Further, whether there are any business structure restrictions imposed by professional or regulatory authorities.

Your Risk Management Profile

This is one important consideration when choosing the best business structure. The main risk of your own small business is if the business fails. Then, your personal assets may be at risk under these circumstances. The degree of risk depends on many factors such as the nature of your industry, whether you commence your own business or purchase a franchise, how much capital you can inject into the business and your ability to grow the business.

Then, one of the most important considerations is how comfortable you feel with low-medium-high degrees of risk. As an business advisor you often attempt to match the business structure to the level of risk the client feels comfortable with. Also, you can often have two business partners with totally different aversions to risk. Under these circumstances you attempt to find a structure that both partners are happy with.

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Different Business Structures

SOLE TRADER

Advantages

1 Low Set Up Costs

This structure can suit people starting up their own business with Low Personal Assets and/or Low Capital to inject into the business

2 Low Add-On Costs for the owner

This is mainly comparing to a company structure, where the owner becomes an employee. If you are an employee, then the business must pay workers compensation insurance and superannuation at 9.5% of your salary.

As a sole trader, you are not an employee, so you don't pay these costs.

The savings would normally be between 10% to 15% of the Owner's Profit. For example, say your Net Profit is $60,000. If you had a company structure then the extra costs would be between $6,000 and $9,000 a year.

This can be particularly relevant for clients with young children. Superannuation is often a low priority at this time in their life cycle and losing say $7,500 from the yearly family budget is a big issue.

3 Low Yearly Administration Costs

The main saving here is yearly accounting/ taxation costs. Companies and Partnerships need to provide a Balance Sheet in accordance with the companies code and tax authorities.

With a Sole Trader, the accountant is normally only preparing a Profit & Loss Statement. The Yearly Accountancy saving would be around $1,000.

Disadvantages

1 High Risk Exposure for your Personal Assets. There is no limited liability - your personal assets are exposed to creditors if the business fails and/or you are unable to repay your debts.

If your business spends significant monies on stock which you hold for a period of time before selling (eg. Retail business) then a sole trader structure may not be a suitable structure to commence your business.

If you have significant Net Personal Assets then you would have to strongly consider whether a Sole Trader structure is the best structure for your business.

If your industry's exposure to litigation is significant then a company or trust business structure maybe a better option for your new business.

If you will be employing a number of employees/ contractors from the start of your business then the Sole Trader option may not be your best option.

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SOLE TRADER

Advantages

3 Low Yearly Administration Costs (cont'd)

Also, with a company you have to pay around $250 to the Australian Securities & Investment Commission as an annual fee for administration of the company.

So, the total saved in yearly administration costs would be in the vicinity of $1,300.

Disadvantages

PARTNERSHIP

Advantages

1 Efficient for Family Tax Purposes

The Tax Office begrudingly accepts that many tradespeople can use a partnership for tax purposes if the following are significant in the business:

- Materials used on jobs
- Plant and Equipment used to derive income
- Commerical Vehicles used to derive income
- Tradespeople as either employees and/or contractors

This can be a more efficient tax structure than a Sole Trader by a big margin

2 Low Add-On Costs for the owner

This is mainly comparing to a company structure, where the owner becomes an employee. If you are an employee, then the business must pay workers compensation insurance and superannuation at 9.5% of your salary.

As a partner, you are not an employee, so you don't pay these costs.

The savings would normally be between 10% to 15% of the Owner's

Disadvantages

1 Cannot be used for Personal Services Income

If only one person derives the majority of the business income, and no significant plant & equipment earns the majority of the income, a partnership structure cannot be used for tax purposes. It would be considered tax avoidance.
Eg - Consultants, Accountants, where only one person is deriving the majority of the income.

2 High Risk Exposure for your Personal Assets. There is no limited liability - your personal assets are exposed to creditors if the business fails and/or you are unable to repay your debts.

The risks are arguably higher than a Sole Trader as a partner has joint and several liability. That means, if your partner is unable to pay the business debts, than you may be liable for the balance of monies owing.

If you have significant Net Personal Assets then you would have to strongly consider whether a Partnership structure is the best structure for your business.

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PARTNERSHIP

Advantages

2 Low Add-On Costs for the owner (Cont'd)

Profit. For example, say your Net Profit is $60,000. If you had a company structure then the extra costs would be between $6,000 and $9,000 a year.

This can be particularly relevant for clients with young children. Superannuation is often a low priority at this time in their life cycle and losing say $7,500 from the yearly family budget is a big issue.

3 Low Set Up Costs

This structure can suit people starting up their own business with Low Personal Assets and/or Low Capital to inject into the business

Disadvantages

2 High Risk Exposure for your Personal Assets (cont'd)

If your industry's exposure to litigation is significant then a company or trust business structure maybe a better option for your new business.

If you will be employing a number of employees/ contractors from the start of your business then the Partnership option may not be your best option.

If your business spends significant monies on stock which you hold for a period of time before selling (eg. Retail business) then a partnership structure may not be a suitable structure to commence your business.

3 Medium/ High Costs for Yearly Administration Expenses

About $1,000 higher than a Sole Trader due to higher accounting/ tax costs. For a partnership a Balance Sheet is completed and the balances at year end of all Assets and Liabilities need to be verified. With a Sole Trader, just a Profit & Loss Statement is produced for tax purposes.

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Different Business Structures

Company

Advantages

1 Limited Liability

The liability of the Shareholders of the company to business creditors is the paid up value of their shares. This structure provides some protection for your personal assets if the business fails.

Disadvantages

1 High Add-On Costs for Owners

Owners are considered to be employees of companies, which means you must pay Workers Compensation Insurance and Superannuation at 9.5%.

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Different Business Structures

Company

Advantages

1 Limited Liability (cont'd)

However, companies do not protect your Personal Assets from:
- Tax Evasion
- False or misleading conduct (Trade Practices Act)
- Trading whilst insolvent

Further, if you provide personal guarantees for business loans and/or have the home as security for a business loan then your personal assets will not be protected if the business fails.

Reducing the risk of exposing your personal assets to the failure of your business venture is a major reason why an owner of a business will choose a company structure to commence their business rather than a sole trader or a partnership.

It is also a major reason for the restructure of a business that commenced as a sole trader or partnership. Either the net personal assets of the owners increase significantly and/ or their business risks increase due to the growth of the business. Then the owner often considers either a company or a family trust for the restructure of the business.

2 Minimising Family Tax

The company tax rate for small business is currently 28.50%, compared to 34.50% for individuals earning over $37,000. The marginal tax rate for individuals earning over $87,000 is 39% (including medicare levy).

This can be a good strategy if the owner's family does not need all the Net Profit for them to live. For example, say the company Taxable Profit is $50,000. After tax, the amount remaining would be $35,750. If this money was left in the business for either paying

Disadvantages

1 High Add-On Costs for Owners (cont'd)

The extra costs would normally be between 10% to 15% of the Owner's Profit. For example, say your Net Profit is $60,000. If you had a company structure then the extra costs would be between $6,000 and $9,000 a year.

This can be particularly relevant for clients with young children. Superannuation is often a low priority at this time in their life cycle and losing say $7,500 from the yearly family budget is a big issue.

This can be partly negated by having a salary/ dividend strategy. Shareholders can receive dividends from their business and this income is not subject to either workers compensation insurance or superannuation.

2 High Set up Costs

Purchasing a company and the professional costs of setup including GST and ABN Registration would normally cost between $800 to $1,000.

3 No Tax Advantages if Income derived by Personal Services

If only one person derives the majority of the business income, and no significant plant & equipment earns the majority of the income, all the income from the business must be taxed in the owner's hands. You cannot leave the income in the company to be taxed at lower tax rates - this would be considered Tax Avoidance.

4 Higher Yearly Administration Costs

Sole Trader vs Company

Compared to a Sole Trader, you have Additional Accounting Fees, as you now have to produce a Balance Sheet, and the accountant needs to verifty the balances of your Assets and Liabilities. Estimated

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Company

Advantages

2 Minimising Family Tax (cont'd)

off company loans or for company working capital purposes, then the tax savings would be substantial. However, if the family needs the $35,750 to pay for home mortgage, education and other costs for the children, then this money will be paid to the individuals as dividend income. This means the $35,750 will be taxed normal personal tax rates and not at the lower company tax rate.

Disadvantages

4 Higher Yearly Administration Costs

Sole Trader vs Company

increase in accounting fees is around $1,000.

Also with a company there are yearly ASIC Fees (Australian Securities and Investment Commission), who administer companies.

Total Estimated increase in Administration Fees between Sole Trader and a Company is $1,300.

Partnership v Company

Similar accounting fees between Partnerships and Companies.

You do pay annual fees to ASIC when a company, so the Estimated increase in administration fees between a partnership and a company is about $300.

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Different Business Structures

Discretionary Family Trust

Advantages

1 **Minimising Family Tax**

Most flexible of structures from a tax minimisation point of view. Beneficiaries can receive income distributions that are not based on their individual efforts for the business. With a company, a Director/ Shareholder would be paid a Salary which is based on their individual contribution for the company.

A Family Trust can save you the most tax, but it depends on who the income is distributed to and what other income they earn.

2 **Ownership Advantages**

Unlike a company, you don't have to include beneficiaries in the ownership of the business directly. They share in the income and capital profits of the business at the discretion of the trustee.

3 **Low Add-On Costs for Owners**

You can distribute all the income to the beneficiaries as an Income Distribution and not pay them a salary. This saves the Add-On Costs of being an employee, which are Superannuation at 9.5% and Workers Compensation Insurance.

The savings would normally be between 10% to 15% of the Owner's Profit. For example, say your Net Profit is $60,000. If you had a company structure then the extra costs would be between $6,000 and $9,000 a year.

This can be particularly relevant for clients with young children. Superannuation is often a low priority at this time in their life cycle and losing say $7,500 from the yearly family budget is a big issue.

Disadvantages

1 **Harder for the Owners to Understand**

Harder for the owners to understand this business structure. I would prefer the client has some awareness of this structure before they commence using it. This is especially the case when they commence a small business for the first time, as they have enough to worry about.

We have an education process when we set up a family trust for the client, to assist them in adapting to this business structure.

As a business advisor, if a business owner does not understand a business structure, then you have to strongly question whether the client will obtain the best result in using the structure.

2 **High Set up Costs**

Family Trusts cost the most to set up as a business structure, as you are purchasing two entities to run the Trust. First you purchase a company to act as the Trustee of the Trust, then you purchase a Trust Deed and normally the accountant's services to assist in the set up.

The Total Estimated Costs of the Structure including GST and ABN registration would be $1,000 to $1,500.

3 **High Yearly Administration Costs**

The yearly tax, accounting and administration costs would be the highest when comparing to a partnership, sole trader and company.

Similar accounting and administration costs when comparing to a company but more tax costs due to more personal tax returns being prepared due to receiving income distributions from the Family Trust.

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Discretionary Family Trust

Advantages

4 **Asset Protection**

A significant number of legal experts believe that a Family Trust with a corporate trustee provides the best protection for your personal assets.

This is because beneficiairies of a Family Trust do not a fixed/ direct entitlement to income or capital profits, it is at the discretion of the Trustee of the Trust. With a company, you have a direct ownership share of the business, you have say 5 shares out of 10, so you have 50% ownership of the company. This direct ownership does not happen when you are a beneficiary of a Family Trust.

This is one of the main reasons why business advisors recommend a Family Trust structure. However, many business advisors also strongly believe the Trustees of the Trust should be a company and not individual people, as it provides better protection of your personal assets. This means it costs more money to set up and administer.

Since 1 July, 2015 the Federal Government has changed the law which means you can transfer to a Family Trust without incurring any capital gains tax liability. Before, your options as an advisor were more limited when a business wanted to restructure. Now, you can offer what many argue is the best protection for your personal assets without incurring a capital gains tax liability. "Win, Win"

As a result of these above changes, our firm will restructure a lot more businesses into a Family Trust than we did in the past. A Family Trust with Corporate Trustee is now a popular entity to use when restructuring a client business.

Disadvantages

4 **No Tax Advantages if Income derived by Personal Services**

If only one person derives the majority of the business income, and no significant plant & equipment earns the majority of the income, all the income from the business must be taxed in the owner's hands.