CREDIT ISSUES

WOODGATE & CO.

Chartered Accountants

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BUSINESS STRUCTURES

Introduction

An important issue to be addressed, prior to commencing a business, is the structure under which the business will be conducted. An inappropriate business structure can cause significant difficulties, if the business subsequently suffers financial distress. The end of a calendar year is a good time to review business structures, so that new structures can be put in place in the new year.

Records of the number of businesses operating in Australia are maintained by the Australian Business Register ("ABR"), the Australian Bureau of Statistics ("ABS"), the Australian Securities and Investments Commission ("ASIC") and the Australian Taxation Office ("ATO"). However, it is difficult to obtain precise numbers of operating businesses.

The ABS conducts annual surveys of businesses in Australia who have ABNs, including sole traders, companies, partnerships and trusts. The latest information from the ABS, as at 30 June 2014, is analysed as follows:

Structure	Number	%
Companies	747,579	36
Partnerships	299,545	14
Sole traders	555,292	26
Trusts	497,230	24
	2,099,646	100%

The Productivity Commission estimated in May 2015 there were a further 500,000 microbusinesses not covered by the ABS statistics.

In October 2015 ASIC recorded that there were 2.28M companies in Australia. Not all companies operate businesses. Many companies hold investments, act as trustees of trusts or are dormant.

In November 2015 the ABR recorded that 11.8M Australian Business Numbers ("ABN") were issued, of which 7.2M ABNs were active. There were 2.6M registrations for goods and services tax ("GST"). Registration for GST is an indicator of an operating business.

Which structure is appropriate?

Some of the factors to be considered in determining which structure is appropriate for a particular business include:

1. the nature of the business, expected duration and the types of assets likely to be owned;

2. how the business and its assets are to be controlled;

3. taxation issues, such as marginal tax rates, transfers of tax losses and the ability to stream income;

4. personal liability issues;

5. the cost of establishing and maintaining the structure(s);

6. succession issues, including the ability to admit new participants or replace existing participants;

7. the complexity or simplicity of the structure; and,

8. protection of assets from creditors, employees and possibly customers.

Sole trader

A sole trader is the simplest and easiest business structure to establish and maintain. There are relatively few compliance costs and usually little paperwork, beyond registering with the ATO for GST. It may be appropriate for a start up or microbusinesses. The sole trader has the benefit of the income tax free threshold, currently $18,200.

However, simplicity comes at significant risk, if the business performs poorly. The sole trader is personally liable for all debts incurred in the business. For spouses of sole traders, this can cause significant concern. The interest of a sole trader in joint personal assets, for example the family home, is available to meet the claims of business creditors, as well as non-business creditors.

Partnership

Partnerships occur when two or more people carry on business in common, with a view to a profit. Partnerships are relatively simple structures and can have low establishment and administration costs. There is no legal requirement to have a formal partnership agreement. Each of the States and Territories have their own legislation to regulate partnerships. Partnerships are frequently used by family business and also for professional services firms.

A partnership is not a separate legal entity. However, it is possible for a partnership to exist in tax law, even if there is not a partnership at law. For tax purposes, the partnership will require a separate ABN, tax file number (“TFN”) and registration for GST. Whilst partnerships are required to file income tax returns, a partnership does not pay income tax. Each partner includes a share of the partnership profit in their income tax return. A partner’s share of losses can, in some cases, offset other income.

In a standard partnership, each partner is jointly and severally liable for all liabilities of the partnership. However, the liability of a partner is greater than that of a sole trader, as the partners are not only jointly and severally liable for the debts of the partnership but also for the actions of other partners and for claims made against the partnership business. In some jurisdictions, this may be modified in limited partnerships or incorporated limited partnerships.

Trusts

At law a trust exists when an obligation is imposed on a person or entity (the trustee) to hold property on behalf of others (the beneficiaries). The trust property is vested in the trustee. Usually, the existence of a trust is documented in a trust deed, although trusts can also be created by operation of law. A trust is not a separate legal entity, although it is a reporting entity for tax purposes. To comply with tax laws, the trustee must apply for an ABN and a TFN for the trust. Whilst trusts are required to file income tax returns, provided that all income is distributed, the trust has no liability to pay income tax. Losses cannot be distributed to beneficiaries.

There are two main types of trusts being express trusts and non-express trusts. An express trust is usually created by a trust deed, setting out the settlor's intentions regarding the trust property and rights of the beneficiaries. Non-express trusts usually result from the operation of law or equity. Private trusts are created for the benefit of individuals or corporate entities. Public trusts are established for the welfare of the public such as charities.

In Australia, the main type of trust used by business is the express, private trust, of which there are three main types:

1. discretionary trusts provide that the beneficiaries have no defined entitlement to the income or assets of the trust. The trustee has discretion on how or when to distribute the assets or capital of the trust;

2. fixed trusts provide that the beneficiaries of the trust have a defined entitlement to the trust income and property. The trustee does not have discretion as to how the trust's assets or income are distributed; and,

3. hybrid trusts combine the features of discretionary and fixed trusts.

The latest statistics from the ATO, as at 30 June 2013, recording the number of trusts who filed income tax returns, are summarised as follows:

	Number	%
Deceased estates	49,220	7
Discretionary	609,450	78
Fixed unit trust	86,931	11
Hybrid trust	9,275	1
Other fixed trusts	16,919	2
Other	8,310	1
	780,105	100

Discretionary trusts are often used to:

(i) separate the ownership of an asset from control or use of the asset;

(ii) protect assets in the event of the insolvency of a beneficiary; and,

(iii) provide flexibility in tax planning, including streaming income to beneficiaries, particularly those with less income from other sources.

A trustee is personally liable for the debts of the trust. However, a trustee has a right of indemnity out of the assets of the trust, for liabilities incurred in administering the trust. This indemnity is retained, even if the trustee is removed. Most trust deeds deny the trustee access to assets of the beneficiaries, if there is a shortfall of trust assets.

In our experience, trusts are one of the more complicated and costly business structures and often poorly understood by clients and sometimes their advisors.

Companies

Most companies are incorporated under the *Corporations Act 2001* (Cth) or its antecedent legislation and are regulated by ASIC. The internal management of a company is regulated by its constitution. A proprietary company need have only one director and one shareholder. It may not have more than 50 shareholders. A public company must have a minimum of three directors. A company is a relatively complex structure. There are fees payable to ASIC on incorporation. There are also annual reporting obligations to shareholders and annual fees payable to ASIC.

A company is a separate legal entity, distinct from its shareholders and directors. The directors of a company have day to day control of the company. A company owns its assets. Shareholders have no legal entitlement to the assets of a company, except following a distribution by a Liquidator.

Whilst the liability of shareholders in companies limited by shares is limited, directors are subject to onerous responsibilities and can be made personally liable for debts of companies in the following cases:

(i) to the ATO under the director penalty notice regime;

(ii) if they trade whilst insolvent;

(iii) in the ACT, NSW, NT and WA for unpaid payroll tax;

(iv) in NSW, if the company was uninsured for workers' compensation; and,

(v) if they have given personal guarantees to creditors.

For taxation purposes a company is a separate legal entity. Following its incorporation, a company is likely to apply to the ATO for an ABN, TFN and, if necessary, for GST. Companies submit their own income tax returns and are currently taxed at a flat rate of 30%. Profits may be retained or paid as dividends to shareholders.

To the extent that income tax has been paid on the profits, declared as dividends, then franking credits are passed on to the shareholders. A company cannot distribute losses or be eligible for the 50% discount on capital gains tax on the sale of assets.

According to the Productivity Commission, 99% of companies are proprietary companies, limited by shares. ASIC's annual report as at 30 June 2015 disclosed 23,792 public companies, of which 2,140 were listed entities or registered schemes.

Conclusion

With the increasing complexity and risk of modern business, it is not unusual for three or four companies, a trust and a superannuation fund to comprise a SME corporate group.

Woodgate & Co. can provide advice on the appropriateness of business structures for your commercial needs, particularly to minimise risk.

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