RK
Rogerson Kenny
BUSINESS ACCOUNTANTS

A BEGINNER'S GUIDE TO SELECTING THE APPROPRIATE STRUCTURE TO OPERATE YOUR BUSINESS

EFFECTIVE BUSINESS STRUCTURES

Brought to you by Rogerson Kenny Business Accountants. We're ready to help you start, run and grow your business.

It's a big step.
Let's take it together.

As accountants we're your trusted advisors, working only for you and in your best interest.

Rogerson Kenny Business Accountants have a wealth of industry knowledge and experience in assisting clients who are considering, or are in the process of, starting or purchasing a business.

We have supported hundreds of clients with everything from arranging the selection and installation of bookkeeping programs to finance applications and, naturally, ongoing accounting and general business advice. We've been by our clients' side, helping them make informed and financially sound decisions for more than 30 years.

Now we want to share our accumulated knowledge with you. That's why we decided to write this beginners guide to effective business structures. We highly recommend that you keep this guide on hand as a reference throughout your journey of purchasing or staring a business.

START THINKING ABOUT YOUR STRUCTURE TODAY

Establishing what type of structure to use for your business is one of the most important decisions you will make as a business owner. It determines everything from your future taxes to asset protection and even the possibility of admitting new partners.

We can't emphasise this enough: the structure is something yor should consider from the beginning.

WE STRONGLY ADVISE YOU TO USE OUR EXPERTISE WHEN LOOKING TO BUY A BUSINESS.

We're happy to be your first port of call and we can help you establish your likely borrowing power and advise on the best business structure to suit your needs.

Remember, no one business structure fits all situations and there are many factors to consider when selecting the best structure for you.

"Rogerson Kenny Business Accountants has provided great service by delivering forward planning initiatives to keep us ahead of current economic trends. They respond to all our questions in short time frames with concise information relating to those queries. The level of professionalism and forethought given to all queries and the great relationship between our business and Rogerson Kenny Business Accountants has far exceeded our expectations. They have all the information we ever require and help us, not only now, but into our future. They are a great bunch of people."

CLINTON PARMENTER, MAVERICK WELDING

Table of contents

Key factors to consider when choosing an effective business structure 4

- Asset protection 4
- Costs 5
- Income tax planning 5
- Capital Gains Tax (CGT) planning 5
- Succession planning 6
- Ease of administration 6
- Legal considerations 7
- Admission of equity members 7

Types of business structures 8

- Sole Trader 9
- Partnership 10
- Company 12
- Discretionary Trust (aka Family Trust) 14
- Unit Trust (aka Fixed Trust) 16

What is the ongoing involvement of the business accountant? 18

Key factors to consider when choosing an effective business structure

ASSET PROTECTION

To choose a business structure that provides asset protection for the owner(s) and their personal and other assets is paramount.

This is especially the case if the business venture is likely to ever borrow money, make a loss, trade in litigious areas or find itself in a situation where its liabilities outweigh its assets.

Depending on the actions of the owners and the sophistication of the lenders, total asset protection may not be achievable. However, this should not deter.

If possible, insurance – in conjunction with asset protection – should always be sought as part of a risk mitigation strategy against being sued.

The personal asset protection of owners is typically achieved where there is a legal separation between the business venture, the owners and their personal assets. Segregation of assets and risk is a great way to achieve asset protection.

AN ASSET PROTECTION EXAMPLE

Take a client with an already existing business structure. In this example assets are held in the trading entity – and therefore exposed to litigation – we would suggest options for transferring those assets out of the trading entity to a more asset protective environment.

REMEMBER, THE PROTECTION OF THE ASSETS IN THE BUSINESS ENTITY ITSELF SHOULD ALSO BE A CONSIDERATION.

For example, holding property or large amounts of cash or other assets where your business is trading is putting those assets at risk. There are ways to avoid holding assets within the business structure and hence exposing them to creditors or legal action.

COSTS

The cost of establishing the business structure and ongoing administration should be considered in conjunction with the other key factors in determining your business structure.

The cost should be one of the last considerations and remember, the cheapest way isn't always the best and may not give you the best result in terms of asset protection, income tax minimisation etc.

Costs typically vary depending on the complexity of the business structure, the goals of the owner, the number of partners involved and the advice sought.

Depending on the structure, complexity and advice sought, your establishment cost may be between $0 and $5,000. This should be deemed an investment for the future, as finding the optimal structure for your circumstances will far outweigh any initial establishment cost.

INCOME TAX PLANNING

Planning for tax is always an important factor when choosing the best business structure for you. Factors like levels of turnover and profit, personal marginal tax rates, income or losses from other related entities, passive investment income and potential beneficiaries should all be considered.

Planning before the purchase or startup can help to ensure that income derived from the business structure is taxed at the lowest possible rate.

For example, a Company is taxed on its profits at 30% while a Discretionary Trust allows profits to be distributed to beneficiaries who are then taxed at their marginal tax rate.

If the beneficiaries' tax rate is less than the Company tax rate of 30%, the business structure of a Discretionary Trust may therefore be a better option to minimise tax.

However, this type of profit analysis requires some future profit assessment. Is the right business structure now going to be the best business structure in ten years time? There is often a trade off, where the business may take a few years to start to making a profit.

Note: It is important to consider the future as we have seen many businesses outgrow their structure.

CAPITAL GAINS TAX (CGT) PLANNING

There are some instances when Capital Gains Tax (CGT) planning can be relevant for the type of business that you are running. Either if the income that is derived is capital in nature, or when the time comes to sell your business.

When starting or buying a business, it's always important to consider the likely impact of CGT in a future sale.

Mechanisms to use in minimising Capital Gains Tax include the CGT 50% general discount and the CGT small business concessions.

CGT 50% GENERAL DISCOUNT

The CGT 50% general discount allows for a 50% reduction in a capital gain where the asset has been held for 12 months or more.

A Company is the only business structure that cannot access this CGT 50% general discount. Any capital gains in a Company are taxed at a rate of 30% (subject to any reductions that may apply to the small business CGT concessions).

CGT SMALL BUSINESS CONCESSIONS

Note: Capital Gains Tax is a complex area and is outside the scope of this resource. Please seek expert advice on any current or future CGT liabilities.

There are four small business CGT concessions available, providing one of the following two criteria are met:

1. The combined net value of CGT assets making the gain, its connected entities and affiliates must not exceed $6 million; or

2. The aggregated turnover of the entity making the gain, its connected entities and affiliates is less than $2 million; and

   a) the asset being disposed of is an active asset; and

   b) the asset satisfies the active assets test.

Further, if the CGT asset is a share in a Company or an interest in a Trust, there are two additional requirements to be met:

1. The significant individual requirement; and
2. The CGT concession stakeholder requirement.

FOUR SMALL BUSINESS CGT CONCESSIONS AVAILABLE:

1. The 15 year exemption.
2. The retirement exemption.
3. The replacement asset rollover.
4. The 50% active asset concession.

You may be eligible for some or all of the mentioned small business CGT concessions, which will give different CGT discounts.

It's important to seek advice when working through this area. Especially when you're planning for a sale (which you indeed should be doing from the time you are buying or starting a business).

SUCCESSION PLANNING

Succession planning is rarely a topic for discussion when buying a business. However, as business accountants we know how big a difference preparation can make when it comes time to sell, admit a partner, pass on to the next generation, list on a stock exchange or wind down.

Business can change course along the way and it is often difficult to foresee some of the likely destinations. Our advice is that you map out most of the likely scenarios and include these in the considerations for finding the best business structure.

For example, a Discretionary Trust will only allow for family members to be involved in a business, meaning it's difficult to admit an unrelated equity or business partner, where a Company or Unit Trust is perfect for those looking to have unrelated parties entering the business, as each party has a fixed entitlement to the income and capital of the entity.

EASE OF ADMINISTRATION

Running a business naturally requires administrative tasks such as record keeping, reporting to the bank, reporting to the Australian Taxation Office, etc.

Further, any administrative structure has fees attached for establishment, registration and renewal as well as ongoing professional fees.

When you start a small business it can seem that the perfect business structure involves multiple entities. While this could be correct in theory, these types of structures might be too complex and costly to administer. The fees to account for three or four entities may be cost prohibitive.

Your administration requirements may differ depending on the structure. Most likely, the sole trader option (as discussed below) is the simplest to administer, yet may not suit the situation with regard to the above topics (asset protection, tax minimisation etc.).

Except for the Sole Trader structure, there are little or no major administrative differences between the most common entities. The level of administration should have a minor weighting on your business structure decision.

LEGAL CONSIDERATIONS

In some industries or circumstances it may be necessary, for legal reasons, for a business to choose a particular structure over another. It could, for example, be that potential suppliers or customers are restricted to only dealing with a certain structure, such as a Company.

ADMISSION OF EQUITY MEMBERS

Some structures are better suited than others to allow for the introduction of equity members. This information is vital in the planning stage as changing course later on to allow for this may be prohibitive, costly and most likely complex.

Typically, a Company or a Unit Trust are good structures to allow for the admission of equity members, as equity members can be allotted shares or units where they then have a fixed entitlement to income and capital.

Note: You cannot introduce an equity participant to a Discretionary Trust that isn't a relative. There is no fixed entitlement as all income and capital distributions are subjected to the discretion of the trustee. So even when starting a business with a family member, a Discretionary Trust can be problematic.

Types of business structures

As we've already mentioned, there are different types of structures you can use to operate your business. No two situations are the same and you should always consult an accountant to determine the best structure for your situation.

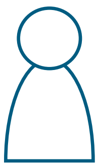
Some issues to consider when looking at a structure are: asset protection, costs, capital gains tax benefits, ease of administration, income tax planning and succession planning.

It is vital to have the best structure for your circumstance in place from the beginning, as moving structures will often not be viable due to stamp duty, legal fees and possible capital gains tax. Moving a business from one structure or entity to another is effectively a sale and may incur some of the transactional costs mentioned above.

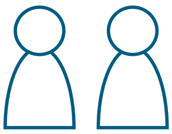
People who don't seek advice for the right structure could be trapped and pay a higher tax rate, lack succession flexibility, risk their personal assets and get a nasty surprise when they sell (e.g. capital gains general discount may not apply).

Make sure you get it right from the start and use this book as guide to get you started.

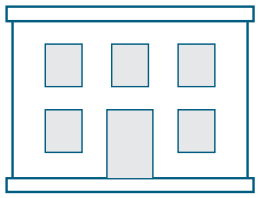
BELOW WE WILL INTRODUCE FIVE COMMON TYPES OF BUSINESS STRUCTURES:



SOLE TRADER

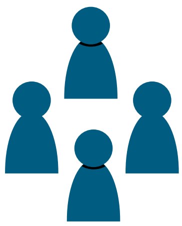


PARTNERSHIP



COMPANY

DISCRETIONARY TRUST



UNIT TRUST

Sole Trader

WHAT IS A SOLE TRADER?

A Sole Trader is a single person operating a business in their own name.

A Sole Trader is a single person, e.g. Helen Jones, registering a business name, such as "Helen's Painting". This means income, expenses, gains and liabilities are all assessed and held by Helen personally.

While operating a business as a Sole Trader provides freedom and autonomy, this business structure can also present risks to your personal finances. One important disadvantage to consider is that the operator's liability is unlimited. If a problem arises, creditors of the business are able to make you personally and totally responsible for all debts. This affects your personal assets and can, in a worst case scenario, send you bankrupt.

ADVANTAGES

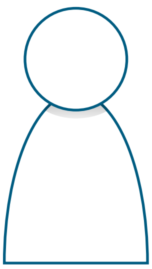
- Low establishment fees.
- Simple business structure and documentation.
- Full control over business decisions.
- The Sole Trader enjoys all profits and capital gains.
- It is easy to wind up this type of business.
- Taxation advantages exist when profits are low.
- Other than the Income Tax Assessment Act and Contract Law, no specific legislation applies.

DISADVANTAGES

- Your capital will be limited by your personal assets.
- Your expertise may be limited, and there is no one else to share the workload.
- You have unlimited legal liability.
- You are personally responsible for all debts and liabilities.
- It may be difficult to pass on ownership, making the business hard to sell if the proprietor dies or experience changing circumstances.
- Taxation disadvantages exist when profits are high.

LIABILITY

As a Sole Trader, you own the assets of your business and are responsible for its liabilities. Liability is unlimited and can extend to your personal assets, including your share of any assets that you jointly own with another person.



SOLE TRADER

As Sole Trader, the business assets and your personal assets mix, as do liabilities. There is no separation between you and the business and therefore between your assets and the business' risk.

You operate off your Tax File Number, although you will need to register an ABN. This structure is the most basic and cost effective, yet does not afford any asset protection, profit sharing or the admitting of a partner.

Partnerships

WHAT IS A PARTNERSHIP?

A Partnership is formed when two or more people (up to 20) or entities such as Family Trusts go into business together with the aim to make profit.

As with Sole Traders, if the partners are operating under their own names, there is no need to register. They must, however, register a business name if they have one.

A Partnership has its own Tax File Number (TFN), and an Australian Business Number (ABN) and lodges its own, separate tax return. There is also no legal requirement for a written agreement, although it is better if there is a document that sets out the full extent of the relationship between the partners and provides a robust dispute resolution process.

ADVANTAGES

- Partnerships are not expensive to set up and you have access to more capital.
- You have pooled knowledge, experience, skills and ability to take time off.
- There are certain tax benefits where the partners are in the same family, such as husband and wife.
- Tax losses within a Partnership are not trapped within a structure but are distributed to the partners (subject to non-commercial loss rules). This includes Discretionary Trusts and Companies of a Partnership.
- Can access CGT 50% general discount and small business CGT concessions.
- Flexible for succession planning and admits other partners.

DISADVANTAGES

- As the business develops there may be disputes over administration and profit sharing.
- Partners can be individually and collectively liable to the defaults of other partner(s).
- If a partner decides to dissolve the Partnership, it may effectively end the business.
- Not ideal for passing of control between generations.

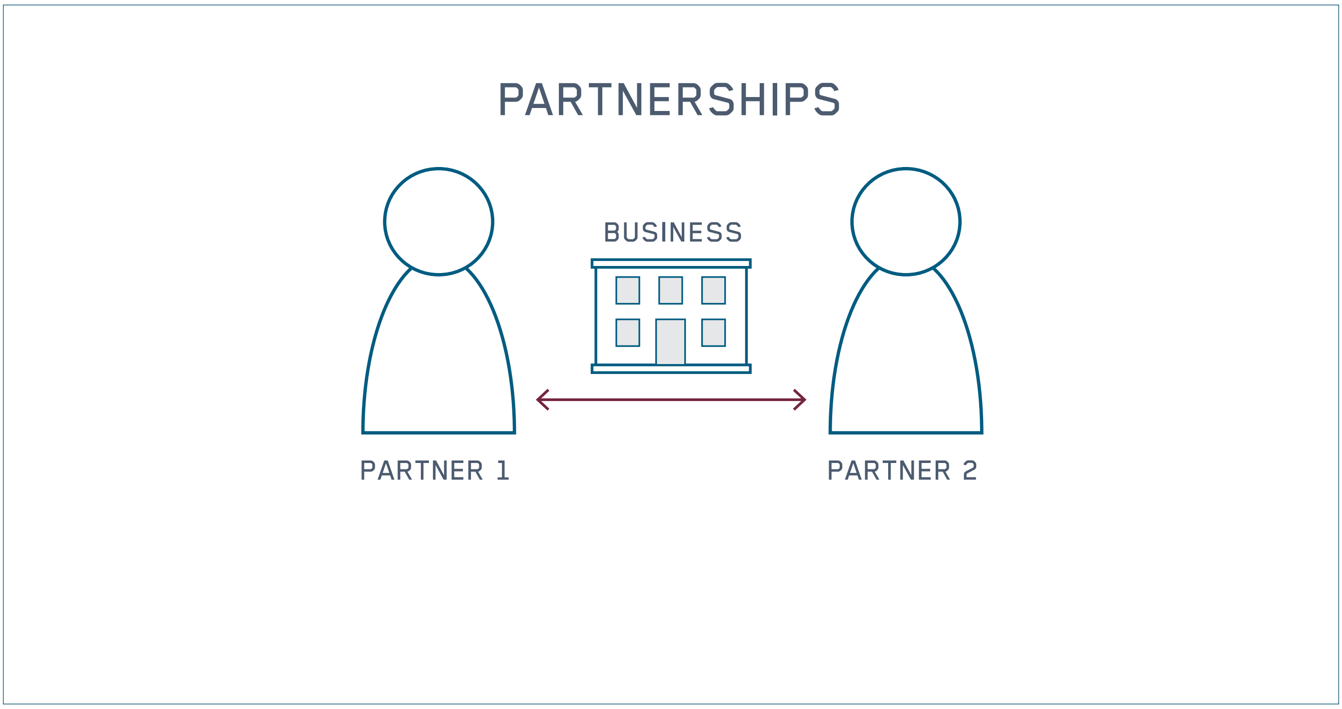
PARTNERSHIP AGREEMENT

Although partnership agreements can be verbal, we recommend a written partnership agreement be prepared with the input of all partners and the advice of a solicitor.

Matters that need to be covered include:

- The nature of the business.
- The role and authority of each partner.
- Proportion of ownership of each partner.
- Each partner’s liability to contribute funds.
- The manner of dissolution.
- The distribution of assets on dissolution.
- The dispute resolution process.

Note: A Partnership can be made up of individual people, a business structure (e.g. Discretionary Trusts) or a combination.


PARTNERSHIPS
BUSINESS
PARTNER 1
PARTNER 2

Company

WHAT IS A COMPANY?

A Company is an independent legal entity able to do business in its own right, sue and be sued. It is an effective structure allowing arm's length parties to go into business together. It is also its own taxpayer.

A Company is owned by the shareholders, who can be both employees and directors. The most popular entity for a small business is a Private Company. The Private Company need only have one director and shareholder. The Company is a separate legal entity, and not subject to a time requirement relative to being wound up, such as a Discretionary Trust (see later), which in most states and territories must be wound up after 80 years.

ADVANTAGES

- Is a separate legal entity (usually with limited liability).
- Can be owned and operated by one shareholder and director.
- Directors, managers and employees have no personal responsibility for debts unless they caused the debts recklessly, negligently or fraudulently.
- 30% flat tax rate.
- Good succession planning options.
- Limited liability can make it easier to attract investment.
- Can own property.
- Assets are protected.
- Directors and shareholders have the support of the *Corporations Act 2001* as a form of binding rules for all to follow.

DISADVANTAGES

- A Company is more expensive to establish than a Partnership or Sole Trader and you must register with the Australian Securities and Investments Commission (ASIC).
- A Company and its directors are regulated by the *Corporations Act 2001*. However, this can be a good thing and will often achieve the same result as a Partnership agreement.
- 30% flat tax rate also applies to low levels of profit.
- Companies may attract higher compliance costs than other business structures.
- Shareholders may have difficulty recovering their investment due to limitations on who can buy shares.
- The capital gains tax 50% general discount does not apply.
- Directors are held personally liable for debts in some instances, such as unpaid superannuation and pay as you go withholding.

TAXATION

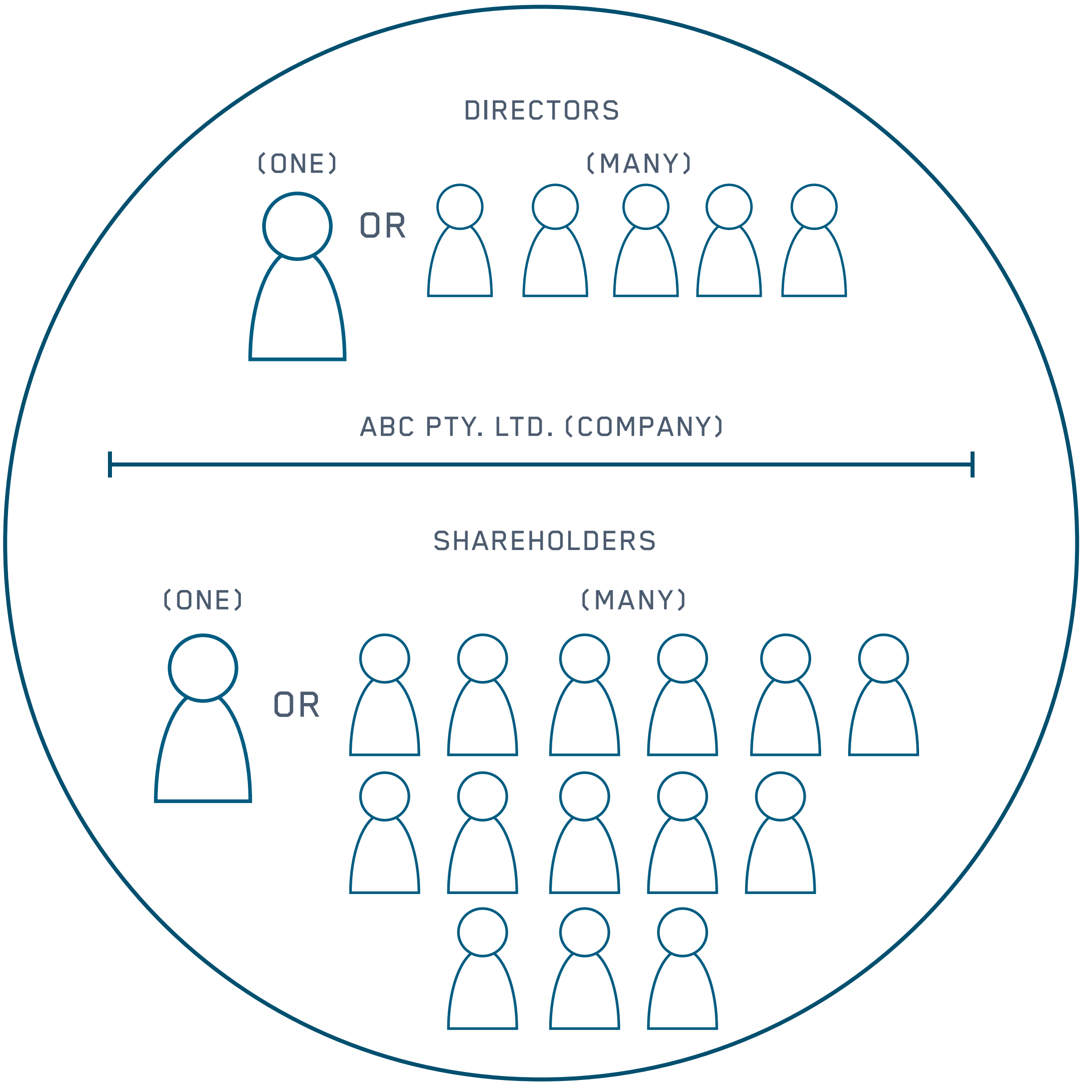
A Company is subject to taxation in its own right. Shareholders receive a credit towards the tax on dividends equal to the relevant amount of tax paid by the Company. A Company pays income tax on its profits; this general rate is 30%.

LIABILITY

Due to limited liability, a Company structure may be advantageous for a high-risk business.

However, major creditors may require directors to personally guarantee the Company's liabilities. Personal liability of directors and employees can also arise if they commit an offence under the *Corporations Act 2001*, or are found to have negligently performed their duties.
A company can sue and be sued in its own right.

TYPICAL COMPANY STRUCTURE



Discretionary Trust (aka Family Trust)

A DISCRETIONARY TRUST IS A TRUST WHERE THE ENTITLEMENTS OF THE BENEFICIARIES ARE NOT FIXED AND THE TRUSTEE HAS DISCRETION TO DISTRIBUTE CAPITAL OR INCOME AMONG THE GROUP OF POTENTIAL BENEFICIARIES. THIS IS DEFINED IN THE TRUST DEED.

WHAT IS A DISCRETIONARY TRUST?

Discretionary Trusts are a very popular way of conducting small business operations in Australia. There are a number of persons who participate in the formation and operation of the Trust. They can be summarised as follows:

SETTLOR

This is the person who establishes the Trust and normally contributes a small amount of money to the trustee for the beneficiaries of the Trust. The settlor should never be a beneficiary or a trustee of a Trust.

TRUSTEES

The trustees are responsible for all aspects of the day-to-day management of the trust. The trustees can either be a Company or individuals. The trustee has extremely wide legal responsibilities for the administration of the Trust.

ADVANTAGES

- Tax minimisation as profits can be sent to beneficiaries of the Trust, who can differ each year and are taxed at their marginal tax rate.
- Asset protection.
- CGT 50% general discount can be used.
- Small business CGT concessions can be accessed.

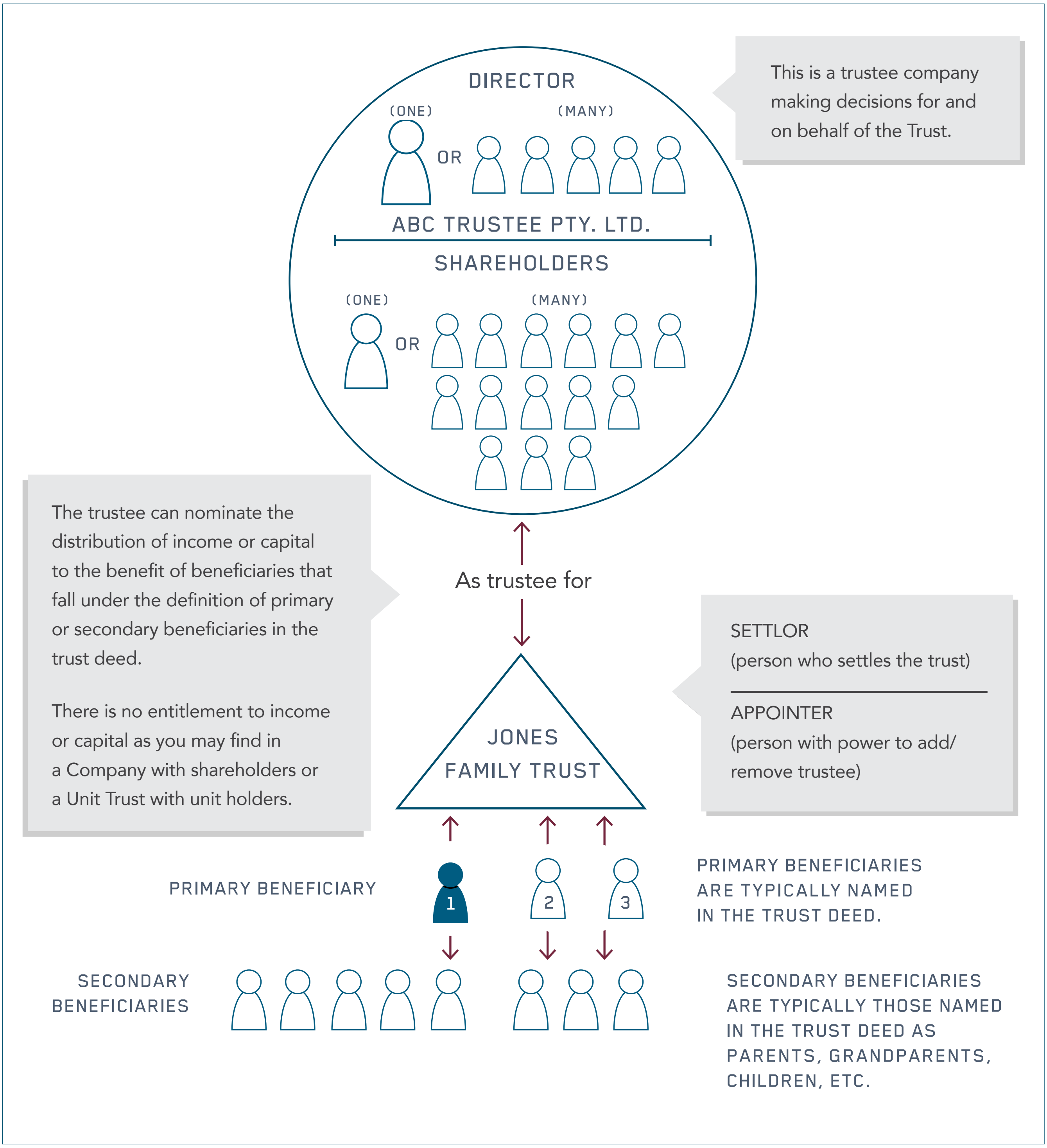
DISADVANTAGES

- More expensive to establish and operate than a Sole Trader.
- Losses are trapped in the Trust.
- Limited succession planning options.
- Tax disadvantages with large profits.
- Business partnerships are limited to the family group.
- No fixed entitlements to income or capital.

TAX AND INCOME IMPLICATIONS

Rather than shareholders, a Trust has beneficiaries who are entitled to distributions of capital and/or income. These distributions are controlled by the trustee and form part of a beneficiary's personal income, subject to income tax and PAYG installment tax.

A FAMILY TRUST IS A DISCRETIONARY TRUST WHERE THE TRUSTEES HAVE MADE A FAMILY TRUST ELECTION. A COMMON REASON FOR WANTING TO OPERATE AS A FAMILY TRUST IS THE FLEXIBILITY IT OFFERS IN RELATION TO DISTRIBUTING INCOME AND ASSETS BETWEEN FAMILY MEMBERS. IN A FAMILY TRUST THE FAMILY STILL MAINTAINS CONTROL OVER ASSETS AND PROPERTY BELONGING TO FAMILY MEMBERS.



Unit Trust (aka Fixed Trust)

A UNIT TRUST IS A TRUST WHERE THE ENTITLEMENTS TO THE INCOME AND CAPITAL OF THE TRUST ARE FIXED IN PROPORTION TO THE NUMBER OF UNITS HELD BY A BENEFICIARY.

WHAT IS A UNIT TRUST?

A Unit Trust is normally used as an alternative to a Partnership, especially where there are people involved in the business entity on an "arm's length" basis.

Each member of the Unit Trust would have a set allocation of units, which are reflected in the control percentage of each unit holder in the Trust. A Unit Trust also has trustees and may have a settlor.

Like a Discretionary Trust, a Unit Trust is not a tax payer in its own right and each year profits need to be distributed to the unit holders of the unit trust.

ADVANTAGES

- Ease of succession.
- Great way for non-related parties to do business together.

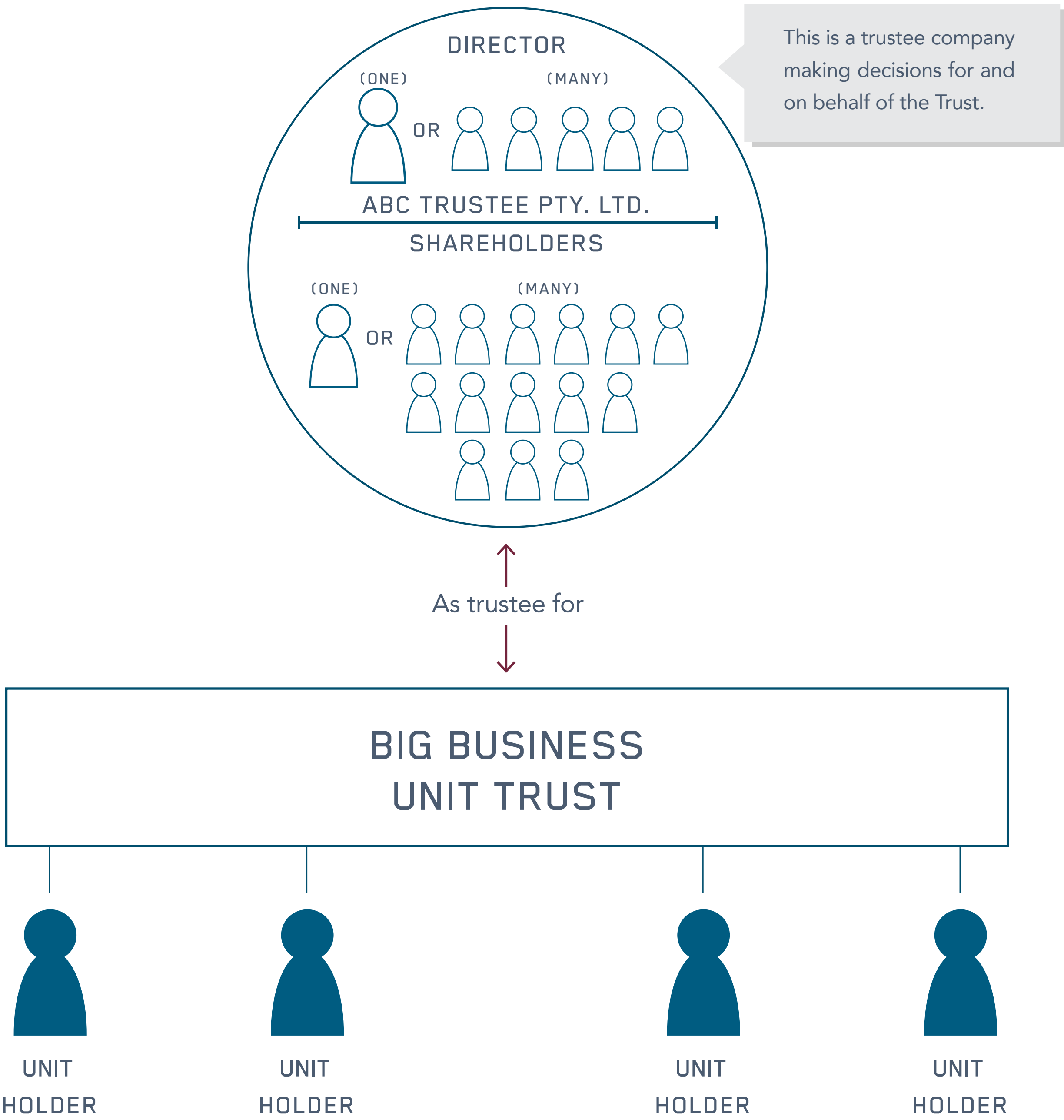
DISADVANTAGES

- A Unit Trust can be a complex and expensive business structure.
- Can be difficult to dismantle.
- Losses are trapped in the Unit Trust.

TAX AND INCOME IMPLICATIONS

Rather than shareholders, a Unit Trust has unit holders who are entitled to distributions of capital and/or income. These distributions are controlled by the trustee and form part of a beneficiary's personal income, subject to income tax and provisional tax. The difference between a Unit Trust and Family Trust is that the beneficiaries have a fixed entitlement as unit holders.

A UNIT TRUST IS A GREAT BUSINESS STRUCTURE WHERE UNRELATED PARTNERS POOL ASSETS TOGETHER FOR A SHORT TERM PROJECT, SUCH AS A PROPERTY DEVELOPMENT, WHERE EACH PARTNER CAN FIX THEIR ENTITLEMENT BASED ON CAPITAL CONTRIBUTED AND CAN MANAGE THEIR OWN TAX AFFAIRS BY CHOOSING THE ENTITY WHICH OWNS UNITS IN THE UNIT TRUST.



Unit holders can be natural persons or an entity. The unit holders have a fixed entitlement to capital and income.

The directors of the trustee company make decisions for and on behalf of the Unit Trust.

What is the ongoing involvement of the Business Accountant?

WE ARE WITH YOU BEYOND THE START-UP

Long-term involvement of a specialist business accountant is just as important as the involvement during the start-up stages.

Providing ongoing advice and direction, preparing accounts, dealing with tax office and bank, keeping you up to date with legislation changes, helping your cash flow and assisting you with business decisions, are all roles that you could expect a business accountant to carry out.

When it does come time to sell, that same business accountant will make sure you receive your best possible sale price. The business accountant will be your guide from the moment of start-up, through the whole relationship leading into a sale. You need to keep the dialogue open and discuss any improvements, acquisitions and ideas and the impact that these may have on tax, sale price and the like.

THE ONGOING ROLE OF THE BUSINESS ACCOUNTANT

The role of the business accountant after the business has been started or purchased can be summarised as follows:

ASSISTING WITH BOOKKEEPING/ ACCOUNTING REQUIREMENTS

- Includes recommending appropriate bookkeeping software and training on said software if needed.
- Providing feedback and ongoing support/ assistance on your file.
- Tax office and other government compliance reporting.
- Annual tax returns.
- Financial statements.
- BAS statements.
- ASIC reporting (if required).
- Communicating with your bank (if required).

TAX PLANNING

- Planning for and minimising future tax.

FORECASTING

- Planning for capital expenditure, taxation, purchase of property and equipment, etc.
- Forecasting the feasibility of new investments.
- The bank may want to see forecast figures, especially if you want to increase your borrowings.

ONGOING DISCUSSIONS

- All aspects of the business need to be constantly evaluated and reviewed.
- You may have the space and thus want to invest in new equipment - can you do it? How will you afford it? What will the impact be on turnover, profit, tax and the sale price? These are questions we are asked often. As business accountants we will prepare a forecast and present this to the bank with an application to finance the purchase.

PLANNING FOR SALE

- When it is time to sell, we can assist you and your broker by providing quality financial statements, prompt answers to questions, full depreciation and asset listing reports, adjusted net profit figure (after adding back owner specific expenses), and information to obtain the best possible price.

Brought to you by Rogerson Kenny Business Accountants.
We're ready to help you start, run and grow your business.

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