SMN accountants

BUSINESS STRUCTURES

Information & Guidance

CONTENTS

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If you are considering starting a business or have already started, it is important to consider and seek advice on the structure your business should have. Differences between the four main business structures can adversely affect your business now and into the future.

At SMN Accountants we can inform you of your options and help you choose the most suitable business structure to give you the best possible start.

The Four Business Structure are:

Sole Trader

Partnership

Company

Trusts

[01] SOLE TRADER STRUCTURE

A sole trader is the simplest business structure and consists of an individual trading on their own. That person controls and manages the business.

TAX ISSUES

ABN

A sole trader who is carrying on an enterprise in Australia may apply for an ABN for their business and use this number for all their business dealings.

GST

A sole trader who is carrying on an enterprise may apply for GST registration. This can be applied for on the ABN application form. A sole trader is required to be registered for GST if their annual turnover is $75,000 or more.

Drawings

A sole trader cannot claim a deductions for money they draw from their business. Amounts taken from sole trader business, and regarded by some as their ‘wages’, are not wages for tax purposes and are not tax deductible.

Superannuation

Sole trader’s are responsible for their own superannuation arrangements. They need to pay superannuation contributions for any employees they employ to help run the business.

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ADVANTAGES

1. Simplicity. The key trait and advantage of being a sole trader lies in its simplicity. Establishing a business as a sole trader is relatively easy as it usually required a small amount of start -up capital and a small amount of paperwork. It also empowers the sole trader to control business assets and oversee all management decisions. Moreover, the reporting requirements are minimal and dismantling the business requires a less complicated process compared to dissolving a company.

2. Claim Business Losses. The income of the business is treated as the persons individual income and they are solely responsible for any tax payable by the business. This offers the tax advantage that tax losses may be offset against the other sources of income of the taxpayer.

3. Capital Gains Tax. For capital gains tax (CGT) purposes, the sole trader is eligible to claim the 50% CGT discount for individuals.

4. Superannuation Contributions. Sole traders are not employees of their business. This means that there is no need to take the sole traders drawings into account in respect of 'compulsory employee" superannuation contributions. A sole trader also does not have payroll tax and workers compensation liabilities in respect of their drawings.

5. Full Deductions. A full deduction for a business-purpose vehicle or sometime even a restructured private -use vehicle (with very minor other use) is allowable for sole traders and partnerships.

DISADVANTAGES

1. Inability to split income. The most significant disadvantage from a taxation perspective is that there is a lack of ability to split income.

2. Proving Fringe Benefits. The sole trader has no liability to vary income between family members from year to year. This means that there is no flexibility in tax planning.

3. Unlimited liability. The sole trader has unlimited liability, this means that all the assets of the sole trader (including personal assets) are at risk.

4. Business End. The business ends when the sole trader ceases working on retirement or death.

5. Access to capital. Sole traders do not normally have access to large sums of capital, which could mean more bank overdrafts or debt.

[02] PARTNERSHIPS STRUCTURES

A partnership is an association of individuals or entities for the purpose of carrying on a business venture or business activity in common with a view to profit. Each partner is entitled to take part in the management of the partnership. For tax purposes, a partnership is an association of people who carry on business as partners or receive income jointly.

Partnership agreements provide evidence that suggests that the parties intend to be in a partnership. Such evidence can include the joint ownership of assets and joint liability for debts, jointly registered business name, and appropriate profit distribution amongst the parties according to the partnership agreement. Also, unlike joint ventures, parties who operate as a partnership share income jointly as opposed to separately.

The maximum number of partners in a partnership is usually 20 but there are exceptions.

ADVANTAGES

1. Splitting Income. The advantages of a partnership are the same as for a sole trader where the partners are treated as individuals for income tax purposes. The one major difference between a sole trader and a partnership is that income may be more easily split between the partners in the partnership.

2. Tax Implications. A partnership is not a separate legal entity and doesn't pay income tax on income earned by the partnership. Instead, each partner pays tax on their share of the net partnership income. As with sole traders any losses from the partnership business will be available to the partner to reduce other income. Accordingly, profits and losses of the partnership are "brought back" into the individual partners tax returns. The structure of a partnership also allows tax preferred amounts (such as tax incentives and tax free capital gains) to be passed through the partners.

3. CGT Discount. Partners are able to access the 50% CGT discounts as they hold an interest in each partnership assets as an individual.

4. Control. The partners own and operate the business so this means they can make all the decisions. This control is sometime difficult to manage because some decisions may require unanimous or joint consent from partners.

5. Capital Variations. Unless otherwise stated in the partnership agreement, the capital of each of the partners can be increased or withdrawn from the partnership without restriction, It is possible for capital contributions to be made in the form of money or property.

6. Structural flexibility. With appropriate drafting it is possible to structure a partnership agreement that allows flexibility for varying profits/losses between the partners on an annual basis.

7. Sharing of burdens. There are a greater number of people to share the workload, losses and legal responsibilities.

8. Simplicity. Partnerships are relatively simple and easy to run. They are also less costly to establish than a company or trust.

9. Flexibility. Partnerships allow for flexibility in the partnership agreement.

DISADVANTAGES

1. Liability. The most significant commercial disadvantage of a partnership is the joint liability of partners. In other words, if any of the partners do not have enough money or assets to pay their share of the debt, the other partners may be personally liable. This arises from the fact that the partnership is not a distinct legal entity. Another consequence of the partnership not being a separate legal entity is that the partnerships as such cannot own property. Moreover, whilst the partnership cannot be convicted of a crime or be subject to other liabilities, individual members of the partnership may be personally liable in crime, tort or contract.

2. Assets Exposure. There is generally no asset protection, meaning that the partners' personal assets may need to be used to repay the business' debts.

3. CGT Disadvantages. The law treats an individual partner's share in the partnership as representing a direct fractional interest in each and every assets of the partnership.

4. Continuity of Business. If there is a change in the membership of partners this will usually alter the partnership agreement unless the agreement stipulates otherwise, affecting the continuity of the business.

5. Selling the Partnership. It is difficult to transfer an interest in a partnership as compared to transferring shares in a company, The main reason for this is because there is a small market for advertising the sale of a partnership interest besides advertisements in solicitor's journals.

6. Limitations to Partners Admitted. As mentioned above, a partnership cannot have more than 20 partners. Note also that some qualified professionals, including doctors and lawyers, are in certain circumstances not allowed to enter into a partnership agreement with an unqualified person.

7. Tax Return. Whilst the partnership doesn't pay tax, its has to lodge an annual partnership tax return to show all income the partnership earned and deductions it claimed for expenses incurred in carrying on the partnership business.

TAX ISSUES

Tax File Number

A partnership needs its own tax file number and uses it when lodging its annual income tax return. This can be applied for on the ABN application form.

ABN

If the partnerships is carrying on an enterprise in Australia, it may apply for an ABN and use this number for all the partnership's business dealings.

Who pays Income Tax?

While the partnership doesn't pay tax, it does have to lodge an annual partnership income tax return to show all income earned by the partnership and deductions claimed for expenses incurred in carrying on the partnership business. The tax return also shows each partners share of new partnership income. Partnerships are not liable to pay PAYG installments. Instead, individual partners may be liable to pay PAYG installments on their share of income from each partnership they are a member of.

Drawings

Partnerships cannot claim a deduction for money partners 'draw' from their business. Amounts taken regularly from partnership business, and regarded by some as their 'wages', are not wages for tax purposes and are not tax-deductible.

GST

Partners may apply for GST registration for the partnership if it is carrying on an enterprise. This can be applied for on the ABN application form. A partnership is required to be registered for GST if its annual turnover is $75,000 or more.

Superannuation

Partners in a partnership are responsible for their own superannuation arrangements as they are not employees of the partnership. But partnership needs to pay superannuation contributions for other employers of the partnership.

ADDITIONAL INFORMATION

Splitting profit

It is important to make sure that the partnership agreement sets out how partnership capital is treated and accounted for throughout the partnership. The partnership agreement should also cover how profit will be split. Only general law partnerships deriving income and able to split profits in different proportions to the partners underlying interest in the partnership. Individuals who have jointly invested in shares or jointly own property will be liable for tax on their share of profits, based on their respective ownership interest in the asset.

New and Retiring Partners

When a new partner is added or an existing partner retires, the current partnership ceases and a new one is created, The ATO does not always require the new partnership to register for a new Tax File Number or ABN. This will depend upon your business circumstances. It is wise to seek professional accounting advice if you are unsure of how a change in your partnership may affect your ATO obligations.

Changing the partnership agreement

Partnership agreements can be changed if all partners involved sign the document once changes have been made. Generally speaking unless partner interest in the partnership changes, no adverse tax consequences will occur.

[03] COMPANY STRUCTURE

A company is a separate legal entity capable of holding assets in its own name. The two main participants in a company are the shareholders and the directors. The shareholders are the owners of the business and the ones who put the capital into the business.

Private, or proprietary companies have no more than 50 non employee shareholders and cannot issue a prospectus and sells shares to the general public.

The Australian Securities and Investments Commission (ASIC) must be notified of any changes in shareholders. The transfer of shares must be done in accordance with the company's constitution, which will require the execution of a transfer of shares form. Whether or not shares are transfered, there may also be a CGT event or stamp duty liability.

ASIC is responsible for monitoring and overseeing the corporations law regime and companies that fall under this jurisdiction. Companies must keep ASIC up to date in regards to company details, change in directorship, changes in shareholders, and must pay an annual review fee per

TAX ISSUES

Tax File Number

A company needs to apply for a tax file number and uses it when lodging its annual income tax return. This can be applied for on the ABN application form.

ABN

A company registered under the *Corporations Act 2001* is entitled to an ABN. A company that is not registered under the Corporations Acts may register for an ABN if it is carrying on an enterprise in Australia.

Who pays income tax?

If a business is run as a company, the money earned by the business belongs to the company. Under the self assessment system, companies have to lodge an annual company tax return which shows the income and deductions of the company and the company's income tax payable. Companies also usually pay PAYG installments, which are credited against their annual income tax liability. A company pays income tax on its assessable income (profits) at the company tax rate, which is currently 26% for base rate entities. The amount of tax to be paid is reduced by any PAYG installments reported during the year. There is no tax-free threshold for companies.

GST

A company may apply for GST registration if it is carrying on a an enterprise. This can be applied for on the ABN application form. A company is require to be registered for GST if its annual turnover is $75.0000 or more. The registration threshold for non profit organisations is $150,000.

Superannuation

Companies need to pay superannuation contributions for all of their eligible employees, including company directors.

ADVANTAGES

1. Companies offer the advantage of limited liability for the shareholders.

2. The imputation tax system ensure that if the company has paid tax, the shareholders will get a credit for that tax paid.

3. Contributions made by the company to a superannuation fund on behalf of employees may be claimed by the company as a tax deduction.

4. Companies are entitled to make tax deductible retirement payment to all employed family members.

5. Losses may be transferred from one company in the group to another provided that there is 100% common ownership.

6. The company structure provides an opportunity to employ the principals.

7. Companies offer some ability to "split" income among family members, this can be done by either employing family members or issuing different classes of shares.

8. Companies offer the ability to obtain CGT deferral where a company is formed to replace existing family structure.

9. The company tax rate, 26%, is much lower than the highest marginal tax rate for individuals, which is 45% plus the Medicare levy.

10. Assets ownership can be transfered in certain circumstances, through a company structure without significant stamp duty costs.

11. Under the *Corporations Act 2001* there is greater flexibility in canceling shares or reducing the paid-up capital of companies, this makes companies a less "rigid" choice of entity.

DISADVANTAGES

1. Where negative gearing starts by a company the tax losses are trapped within the company. This often means, that negative gearing should be structured outside the company.

2. Tax preferred amounts received by a company will be subject to tax on distribution to shareholders. This inability to pass through tax preferred amounts to shareholders without causing further taxation stems from the way that the imputation system operates.

3. The commercial costs in maintaining a corporate entity can be considerable.

4. The incorporation of an enterprise means that the principals become employees of that company. This may give rise to exposures to payroll tax and "compulsory" superannuation.

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[04] TRUST STRUCTURE

A trust is an obligation imposed on a person to hold property or income for the benefit of others (who are known as beneficiaries).

A trust does not have a separate legal existence like a company. All transactions in respect of the trust are undertaken by the trustee. Consequently, a transaction entered into by the trustee is a personal obligation.

ADVANTAGES

1. Unit trusts have several similarities to companies in that the trust is separate from the unit holders; the unit holders subscribe equity on units and the principals may be employed by the trust.

2. A units trust need not pay tax. Rather, the unit holders incur the tax on taxable profits derived by the unit trust.

3. The benefit of tax free capital gains and tax incentives may be passed through the unit holders provided that appropriate structuring undertaken.

4. Unit trusts offer different forms of income to different unit holders. This is achieved under modern forms of unit trust deeds by providing for difference classes of units.

5. The 50% CGT discount is available to all trusts in relation to disposal of assets.

DISADVANTAGES

1. A tax loss in a unit trust cannot be disturbed to the unit holders. It is important therefore, that those unit trusts are structured in such a way that losses are incurred at the unit holder level rather than the unit trust level.

2. Capital gain cannot be deferred through the CGT roll-over relief provision when assets are transferred into a trust.

TAX ISSUES

Tax File Number

A trust must have its own tax file number and uses it when lodging its annual income tax return. The trustee needs to apply for a tax file number in its capacity as trustee of the trust. A tax file number can be applied for on the ABN application form.

ABN

If the trust is carrying on an enterprise in Australia, the entity that is trustee may register for an ABN in its capacity as trustee of the trust.

Who pays Income Tax?

Whether or not a trust has a tax liability depends on the type of trust, the wording of its trust deed and whether the income earned by the trust is distributed (in whole or part) to its beneficiaries. Where the whole of the net trust income is distributed to adult resident beneficiaries, the trust will have no liability, Where all or part of the net trust income is distributed to either non-residents or minors, the trustee will be assessed on that share on behalf of the beneficiary.

In this case, the beneficiary is required to declare that share of net trust income on their individual income tax return, and also claim a credit for th amount of tax liability paid on their behalf by the trustee. Where the net trust income is accumulated by the trust, the trustee will be assess on that accumulated income at the top individual marginal rate.

If a trust is carrying on a business, each year all income earned by the trust and deductions claimed for expenses incurred in carrying on that business must be shown on a trust tax return. The Tax return also show the amount of income distributed to each beneficiary.

Trusts are not liable to pay PAYG installments. Instead, the beneficiaries or trustees may be liable to pay installments.

GST

If the trust is carrying on an enterprise, the entity that is trustee can register for GST in its capacity as trustee of the trust. This can be applied for on the ABN application form. A trust is required to be registered for GST is its annual turnover is $75,000 or more. The registration threshold for non- profit organisations is $ 150,000.

Superannuation

Trusts may need to pay superannuation contributions for trustees if they are also employed by the trust. A trust also needs to pay superannuation contributions for other employees of the trust.

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[05] PARTNERSHIP & TRUSTS

A partnership of discretionary trusts is simply a partnership in which each partner is the trustee of a discretionary trust, that is, each discretionary trust is the partner.

A partnership of discretionary trust is more complex than a normal partnership of individuals, so it may be wise to appoint an agent or corporate manager. An agent or manager will act on your behalf for administrative purposes, such as entering into contracts on behalf of the partnership of discretionary trusts.

Partnership agreements can be changed if all partners involved sign the document once changes have been made. Generally speaking, unless partner interest in the partnership changes, no adverse tax consequences will occur.

ADVANTAGES

1. Although each partner is still jointly and severally liable for the partnership's debts, the trustee personal assets are generally protected. This is an important advantage when compared to a general partnership of individuals.

2. Each principal has a fixed interest in the capital and income of their partnership. This occurs through their discretionary trust.

3. It is also easier to make tax-free distributions through a partnership of discretionary trusts, when compared to unit trusts and companies. It may also be easier to access the concessional CGT treatment (provided by the small business tax concession).

4. Each partner is independent of the other.

5. The individual principals can be employed by the partnership of discretionary trusts, which will make them eligible for benefits such as superannuation, This would not be possible under a partnerships of individuals.

DISADVANTAGES

1. This structure is far more complex than a partnership of individuals, and could be more expensive to set up and operate.

2. Some external parties may find it hard to understand how the partnership is operated.

TAX ISSUES

Tax File Number

A trust and the trustee (each respective partner) must have its own tax file numbers, which will be used when lodging its annual income tax return. The trustee needs to apply for a tax file number in its capacity as trustee of the trust. A tax file number can be applied for on the ABN application form.

ABN

If there is no agent, the partnership should obtain and ABN and register for GST. If there is an agent, partners need to decide whether the agent should also obtain an ABN and register for GST. This would cause external parties to deal with the agent rather than inquiring about the structure behind the agent.

Who Pays Income Tax?

Whether or not a trust has tax liability depends on the type of trust, the wording of its trust deed and whether the income earned by the trust is distributed (in whole or part) to its beneficiaries, Where the whole of the net trust income is distributed to adult resident beneficiaries, the trust will have no liability. Where all or part of the net trust income is distributed to either non-residents or minors, the trustee will be assessed on that share on behalf of the beneficiary.

In this case, the beneficiary is required to declare that share on behalf of the beneficiary. In this case, the beneficiary is required to declare that share of net trust income on their individual income tax return, and also claim a credit for the amount of tax liability paid on their behalf by the trustee. Where the net trust income is accumulated by the trust, the trustee will be assessed on that accumulated income at the highest individual marginal rate.

If a trust is carrying on a business, each year all income earned by the trust and deductions claimed for expenses incurred in carrying on that business must be shown on a trust tax return. The Tax return also shows the amount of income distributed to each beneficiary.

Trusts are not liable to pay PAYG installments. Instead the beneficiaries or trustee may be liable to pay installments.

GST

If the trust is carrying on an enterprise, the entity that is trustee can register for GST in its capacity as trustee of the trust. This can be applied for on the ABN application form. A trust is required to be registered for GST if its annual turnover is $75,000 or more. The registration threshold for non-profit organisations is $150,000.

Superannuation

Trusts may need to pay superannuation contributions for trustees if they are also employed by the trust. A trust also needs to pay superannuation contributions for other employees of the trust.

[06] BUSINESS STRUCTURE COMPARISONS CHART

Entity	Income Tax	Capital Gains Tax	Land Tax	Asset Protection
Sole Trader	No income splitting. Must substantiate business deductions. Losses can be offset against profits.	50% discount (on goodwill with the sale of the business) & main residence exemption & small business concessions available.	Threshold available. Principal residence exemption available.	None except by insurance. Business & non- business assets exposed.
Partnership	No income splitting. Losses not trapped in partnership, distributed to partners & can be offset against other profits. Can vary profits & losses payable to partners years to year.	Not part of partnership income. Divided between partners in accordance with interest in partnership. 50% discount, main residence exemption & small business concessions available.	Threshold available. Principal residence exemption available.	None except by insurance and may also be exposed to partners debts due to joint and several liability of partners.
Company	26% flat tax. Dividends taxed. Franked dividends pass on tax paid. Restrictions on internal loans. Losses trapped in company. Limited splitting through classes of shares.	No 50% discount. No main residence exemption. Tax free gains to company are taxed without imputation as dividends if distributed. Small business concessions available. Losses trapped in company.	Threshold available. Principal residence exemption not available. Related corporations may be assessed together. Relief possible if 60% of shareholders would suffer serious hardship.	Shareholders protected but value of their shares available to their creditors on bankruptcy. Directors potentially liable if trading while insolvent.
Unit Trust	Taxed at unit holders' level so depends on structure of unit holders. Good for joint ventures. Losses trapped in trust.	Depends on unit holders. 50% discount applies. No main residence exemption. Small business Concessions available. Losses trapped in trust.	Principal residence exemption not available. Special Notifications required.	Unit holders protected but value in their units available to their creditors. Trustee indemnified.
Discretionary Trust	Maximum ability to split income. Biggest range of recipients. Losses trapped in trust.	50% discount. No main residence exemption. Maximum ability to split. Small business concessions available. Losses trapped in trust.	No threshold.	Trustee company. Beneficiaries no value in their protentional interest for creditors. Trustee indemnified.