

# BUSINESS STRUCTURES - LEGAL ASPECTS

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Before setting up a small business, you need to carefully consider what the appropriate structure is. Often, the advice of a solicitor and accountant is necessary to decide what the most appropriate structure is for your needs.

The most common small business structures, are:-

- sole trader;
- partnership;
- company;
- trust - unit ,discretionary or hybrid. (A trust may have a corporate trustee)

Depending on which structure you choose, a variety of different issues will be affected including:-

- the nature of the structure;
- governing laws and documentation required;
- formalities and procedures both on establishment and for the on-going operation of the structure;
- costs;
- liability of participants for business debts;
- retirement, admission of participants, death or bankruptcy;
- control by participants;
- employment issues- will federal or state legislation apply?
- tax issues;
- succession issues.

## **SOLE TRADER**

### **NATURE**

This is the simplest form of business organization. It involves only the principal. Often, when businesses set up, they start out with the principal acting as a sole trader. This does avoid the additional expense of a company or trust.

### **GOVERNING LAW/DOCUMENTATION**

No documentation is needed to establish a sole proprietorship and there is no law specifically dealing with that structure. Of course, taxation, trade practices, industrial relations and discrimination laws all apply.

## **OPERATING PROCEDURES**

There are no special procedures that apply to sole proprietors. If you decide that this is the structure for you, you just need to obtain an ABN , keep proper books of account and bank accounts and all other financial and required taxation records records relating to the business.

## **BUSINESS NAME**

If you operate as a sole trader you do not need to register a business name if you intend to operate under your own name However, if you wish to have any other name for the business you would need to register this name with the Department of Fair Trade.

## **LIABILITY**

As a sole trader you are personally liable for all of the debts of the business. Therefore, you put all of your assets (either business or personal) at risk as creditors can seek to recover debts owing from any of your assets.

## **RESTRUCTURING/RETIREMENT/ADMISSION**

A restructure, admission of extra persons to the business or retirement by sole trader will mean the sole trader structure is terminated.

## **CONTROL**

Sole trader has total control over business decisions.

## **TAX**

Tax is payable on income earned by a sole trader. Losses can be carried forward.

## **SUCCESSION**

A sole trader can leave the business as desired in his or her Will.

# ***PARTNERSHIPS***

## **NATURE**

A partnership is a contractual relationship between the partners. The partners need not be individuals. A partnership can exist between two or more individuals or companies or trusts or any combination of these.

Participation in a partnership imposes duties upon the parties including:-

- to render true accounts and full information of all things affecting the partnership to any partner;
- to account to the partnership for any benefit derived personally without the consent of the other partners from any transactions concerning the partnership;
- not to compete with the partnership;
- general duty of good faith between partners.

## **GOVERNING LAW/DOCUMENTS**

Partners can reach any agreement they wish. If the agreement is oral, and not in writing, then the law will deem a partnership where you are involved in a common enterprise and your profits are shared.

If you are proposing to enter into a partnership, we strongly recommend that a partnership agreement be prepared which sets out all of the important aspects of your proposed partnership arrangements.

## **COSTS**

The only specific cost is preparation of the partnership agreement. The amount involved depends upon the complexity of the partnership. An ongoing cost would be the preparation of partnership tax returns by your accountant.

## **LIABILITY**

Partners are jointly and severally liable to third parties for all the debts of the partnership. This means that all partners are liable for all partnership debts and not just their proportion of them. For example, if one of the partners cannot meet his or her share of the partnership debt then the other partners are obliged to effectively meet more than their proportionate share. If this occurs the partners can seek a contribution from the defaulting partner.

A partnership may be more exposed you to more personal liability than a sole trader as each partner is responsible for the activities of all other partners where partnership business is concerned.

## **RESTRUCTURING/RETIREMENT/ADMISSION**

The retirement and admission of partners can be quite complex. A number of issues may come into play:-

- ✓ the value of work in progress;
- ✓ stamp duty (on unencumbered value of interest being transferred);
- ✓ capital gains tax;
- ✓ pre-emptive rights of existing partners.

## **CONTROL**

The partners own and operate the business and make decisions. The partnership agreement should specify which decisions require majority, special majority or unanimous support.

## **TAX**

Partnership income and losses can be distributed to each partner according to the partnership agreement.

## **SUCCESSION**

For individuals who own an interest in a partnership, that interest can be left by a Will. Sometimes the beneficiary under the Will may not be an appropriate person to participate in partnership business. The Partnership should have some pre-existing

arrangement to address this issue.

## **COMPANIES**

### **NATURE**

A company, unlike sole traders and partnerships, is recognised at law as a separate legal entity. It possesses the same powers and liabilities as a natural person in terms of being able to carry on business. It can sue and be sued.

There are a number of different types of company but the most common in the small business context is a proprietary limited company.

The essential feature of a proprietary limited company is that the shareholders liability is limited to any unpaid money on issue of shares. Under Corporations Law directors may also be personally liable for debts incurred after a company has become insolvent.

A company exists as an entity separate from its shareholders and directors.

### **HOW MANY DIRECTORS**

Companies can consist of one or more directors. It may be that a single director company will adequately meet your needs.

### **GOVERNING LAWS AND DOCUMENTS**

The Corporations Law governs the incorporation and operation of companies. A company's controlling documentation is its memorandum and articles of association. They establish the internal rules of the company and are binding on the company, the directors and shareholders.

### **FORMALITY/PROCEDURE**

Several issues need to be addressed prior to incorporation including:-

- ✓ details of director/s and secretary;
- ✓ location of registered office;
- ✓ rights attaching to shares - capital, dividend and voting rights;
- ✓ any special arrangements relating to appointment of directors and directors powers for management of the company.

### **COSTS**

Generally, the costs of acquisition of a shelf company are around \$600 including fees for incorporation and reservation of names.

### **LIABILITY**

The liability of directors and shareholders has been referred to above.

Most lenders and suppliers will require that directors give personal guarantees before advancing funds or supplying goods to a proprietary limited company.

## **RESTRUCTURING/RETIREMENT/ADMISSION**

The shareholding in a company can change by issue of further shares or transfer of existing shares. The more important issues to be considered are:-

- ✓ there is no stamp duty payable on transfer or issue of shares unless the company is "land rich" as defined in the Stamp Act;
- ✓ capital gains tax;
- ✓ pre-emptive rights of existing shareholders;
- ✓ there are roll over provisions under the Stamp Act and Income Tax Assessment Act providing exemptions for company restructures in certain circumstances.

## **CONTROL**

Control of the company rests ultimately with its shareholders who determine the composition of the board of directors.

The management of a company is the responsibility of the directors.

## **TAX**

A company pays tax on profits and capital gains. A shareholder receives dividends from a company. A system of franking operates to eliminate or reduce the tax that would otherwise be payable on those dividends.

## **SUCCESSION**

Shares in a company can be left by Will.

# **TRUSTS**

## **NATURE**

A Trust is an arrangement for the holding and management of property by one party (the trustee) for the benefit of another or others (beneficiaries) or for a specific purpose. A trust is not a separate legal entity, it is merely a relationship existing with respect to the property the subject of the trust.

One of the key aspects of a trust is the fiduciary relationship between the trustee and the beneficiaries. The trustee is bound to exercise powers and to act in good faith and in the interests of the beneficiaries.

A Trustee may be one or more companies or individuals but not more than four. The two most common forms of trusts used in small business are discretionary trusts and unit trusts. The rules for these trusts will be contained in a trust deed.

## **DISCRETIONARY TRUSTS**

In a discretionary trust, there are a number of beneficiaries or classes of beneficiaries named and the trustee may exercise a discretion as to the distribution of income and/or capital among one or more of the beneficiaries. Accordingly, discretionary trusts are popular for their flexibility and the tax advantages they offer.

The beneficiaries do not have any legal interest in the asset of the trusts, they merely have the right to ensure that the trust rules are followed and that the exercise of the trustee's discretion is made bona fide. This discretion means that commercially they are not suitable as a structure involving unrelated participants. In business ventures involving more than one family it is common for the business to be operated by a unit trust, the units in which are held by separate family discretionary trusts for each family.

### ***UNIT TRUSTS***

A unit trust is a form of fixed trust in that the identity and interest of each of the beneficiaries is determined. The interests in the trust assets are divided into a number of equal interests known as units which together represent the whole of the trust fund. The trustees have little or no discretion to distribute income other than in accordance with the units.

### ***HYBRID TRUSTS***

A hybrid trust is a combination of fixed and discretionary trust. It is commonly used in situations where it is appropriate to distribute some discretionary amounts to some working directors/beneficiaries before attending to a profit distribution to unit holders on the basis of units held.

### **GOVERNING LAWS/DOCUMENTS**

The law relating to trusts is covered by the Common Law and the Trust Act 1973.

### **COST**

Normally, the cost of establishing a tailored discretionary unit or hybrid trust will range from \$600 depending on complexity. If there is a corporate trustee the cost of incorporation must be added.

### **LIABILITY**

The trustee is personally liable for all the liabilities of the trust. Therefore, depending on the activities of the trust, a company may be the preferred trustee.

Under a trust deed the trustee will usually have an indemnity payable from the assets of the trust for liabilities properly incurred.

Under Corporations Law directors of a trustee company may be personally liable for trust debts where there is no indemnity under the trust deed to pay the debt from trust assets or if the trust company is insolvent.

### **RESTRUCTURING/RETIREMENT/ADMISSION *DISCRETIONARY TRUSTS***

Beneficiaries under a discretionary trust do not have an interest that can be transferred. Where the beneficial interest under a trust has changed Stamp duty is payable on the unencumbered value of the assets of the trust at ad-valorem rates.

### ***UNIT TRUSTS***

Units in a unit trust can be transferred in a similar way to shares in a company.

## **CONTROL**

The trustee has control of a trust subject to the beneficiaries limited rights to ensure that the trust is properly administered and discretions exercised bona fide. Often a discretionary trust deed will provide that a nominated person has the power to appoint a new trustee. In a unit trust, unit holders or a nominated person may have the power to appoint a new trustee.

## **TAX**

The trustee has the discretion to distribute income under a discretionary trust. In a unit trust income is to be distributed according to the rights of the unit holders. In both a discretionary and a unit trust losses are trapped in the trust and cannot be distributed. Losses in a trust can be carried forward in the trust.

## **SUCCESSION**

The rights of a beneficiary under a discretionary trust cannot be passed by Will. Units under a unit trust can be passed by Will.

## **CONCLUSION**

When deciding which structure is most suitable the owners of the business must weigh up taxation and stamp duty issues together with ease of set-up and operation for each structure. The issues may be complex requiring appropriate professional advice.