Business Structures

Which Business Structure Should You Choose?

An important decision to make when starting a business is choosing the business structure that best suits your needs.

Some of the factors to consider are personal financial liability, tax implications, access to business profits, establishment costs and risk exposure.

Consulting your accountant and/or solicitor will assist you in making a better decision.

There are a number of business structures available, of varying complexity, each with advantages and disadvantages. The most common business structures are sole trader, partnerships and proprietary limited company.

Set out below are the definitions and a summary of the advantages and disadvantages of each.

Sole Trader

A sole trader is an individual who runs the business without partners or a company structure.

It is the most common form of business organisation because of its simplicity of formation and offers complete managerial control to the owner.

However, the owner is also personally liable for all financial obligations of the business.

Advantages

- Easy to set up - less complex structure.
- You manage and operate your own business and make all decisions.
- You are not constrained by franchise or other procedural obligations
- Inexpensive to establish and operate.
- Least reporting requirements.
- Your losses may be offset against any other income or future earning.

Disadvantages

- You are your business - often your business will operate only if you work.
- You do not have any structured support (such as a franchisor)
- You are personally liable for all business debt.
- You continue to pay tax at personal income tax rates.
- Fewer options to raise finances may limit your business.

Company

This is a legal entity that is separate from those who founded it – in terms of accounting, taxation and legal liability.

A constitution of the company will govern the operation of the company and the role, powers and functions of its officeholders – the director and secretary – as does the Corporations Act 2001 (Cth) and other legislation.Like a person, the company can be taxed and can be held legally liable for its actions.

Under the Corporations Act 2001 (Cth), every company in Australia has a unique, nine-digit number, an Australian Company Number, or ACN, which must be shown on a range of documents. The purpose of the ACN is to ensure adequate identification of companies when transacting business.

A shareholder's agreement is recommended – see below.

Advantages

- Liabilities of the shareholders are limited to their subscribed share capital and any debts personally guaranteed.
- The company is a separate legal entity, which may enter into agreements, can be sued, can sue others.
- Retained profits are taxed at the company income tax rate.
- Ease in attaining ownership in the company by acquiring shares.
- Ease of ownership change.
- Continuity of the company's existence - not dependent on the owners.
- Disadvantages
- Establishment, administrative, record keeping and operating costs are high.
- Increased statutory requirements for taxation and Corporations Act.
- Imposition of fines for office holders in the event of a breach of the Corporations Act.
- Revenue and capital losses must be retained by the company - cannot offset owners' incomes.

Partnership

This involves two or more people/entities who agree to share in the profits and/or losses of a business.

Legislation also governs the operation of the partnership.

A partnership agreement is recommended. The important features to include in a partnership would be:

- The commencement date and duration of the partnership.
- The treatment of partnership property and leases undertaken for the partnership.
- Conditions under which partners can assign or change their interest in the partnership.
- Apportionment method for profit, capital and losses of the partnership.
- Person/s of authority to make payments on behalf of the partnership.
- Method of valuation of assets upon dissolving or altering the partnership.
- Whether majority decisions of partners govern all matters.
- Agreement to engage an independent accountant.

In the absence of a formal written partnership agreement, the law will assume that each partner has an equal share in the business.

Advantages

- Inexpensive to establish and operate.
- Ability to split income on level of ownership.
- Responsibility for the operation of the business is shared.
- Ability to raise finance for the business is enhanced.
- Capital losses may be offset by other non-business capital gains derived by the individual owners.

Disadvantages

- Each partner is fully liable for the full debts of the partnership.
- There is limited flexibility in distributing profits from property.

Limited Partnership

The NSW Partnership Act makes provision for a limited liability partnership structure whereby the liability of a partner contributing capital can be limited to the amount of financial contribution, provided that person does not take part in the management of the business.

The advantage of the limited liability partnership is that it allows an investor to invest in a partnership without being liable beyond the extent of their financial investment, provided certain conditions are met.

Joint Venture

An arrangement involving at least two business entities joining together for a specific commercial/business purpose, for instance the redevelopment of property, exploitation of particular intellectual property rights, etc to enhance the productive potential of both companies.

Like a partnership, profits and losses are "passed through" to participants to report on their individual income tax returns.

A joint venture may involve a new entity part owned by each participant (incorporated joint venture) or a contractual arrangement only (unincorporated joint venture) that is managed by another entity.

A joint venture agreement would normally govern the roles, functions, and entitlements of each participant. Though such an agreement is not essential it is highly desirable.

Advantages

- Inexpensive to establish and operate.
- Ability to split income on level of ownership.
- Responsibility for the operation of the business is shared.
- Ability to raise finance for the business is enhanced.
- Capital losses may be offset by other non-business capital gains derived by the individual owners.

Disadvantages

- Individual liability for joint venturers
- Potential for disputes amongst joint venturers

Trust

A separate legal entity in terms of accounting, taxation and liability, but with different tax treatment to that of a company.

A trust deed will govern the operation of the trust and the role, powers and functions of the trustee.

The duties and obligations of the trustee are also governed by common law and statute.

There are various forms of trusts – discretionary trusts, unit trusts or hybrid trusts, depending on the nature and purpose of the trust.

Advantages

- In discretionary trusts, the trustee has discretion in terms of distributions to beneficiaries
- The trust is a separate legal entity, which may enter into agreements, can be sued, can sue others.

- Continuity of the trust's existence - not dependent on the beneficiaries.
- Disadvantages
- Establishment, administrative, record keeping and operating costs are high.
- Statutory and common law obligations on trustees
- Increased statutory requirements for taxation and Corporations Act.
- Revenue and capital losses must be retained by the trust - cannot offset owners' incomes.

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