

Illawarra Small Business Assistance

BUSINESS STRUCTURES

SOLE TRADER

This is the most common structure adopted by those starting a business as it is the cheapest and least complicated option.

Taxation issues are pertinent and the structure is well suited to a person who does not have family members to split business profits with. It is also an appropriate way of operating when a business is being developed and losses are being incurred. However, when the business starts to make profits the business income will add to any employment income the owner may also have. This could result in tax being paid at higher rates of 40% and 45% when total income exceeds the relevant thresholds (\$80,000 plus and \$180,000 plus). If on the other hand, business net profit is the sole income source, then taxable income would need to exceed \$120,000 before the company tax rate of 30% would be advantageous.

Legal liability and protection of personal assets are areas that can be a major disadvantage for sole traders. If the business is the subject of a legal claim and insurance does not fully cover damages awarded, the personal assets of the sole trader can be attached.

Unlike a company, in the event of business failure with outstanding debts, the personal assets of the owner can be pursued legally by unpaid creditors.

Income protection insurance is recommended for sole traders as they are unable to obtain WorkCover benefits.

Capital Gains Tax is not a major issue for owners operating as a sole trader. The general 50% capital gains tax exemption is available to individual taxpayers. If, after also applying the 50% active assets discount available to qualifying small business enterprises, only 25% of a capital gain on the sale of a business is assessable. Further, if the resulting capital gain is rolled into a superannuation fund, the business would have to be sold for over \$2 million in profit, before capital gains tax would be payable.

PARTNERSHIP

A partnership is not a legal entity and does not pay **taxation** in its own right. Any profits/losses made by the partnership are distributed to the partners, and tax is paid at their applicable tax rates. After a sole trader, partnerships can be the next most cost effective tax structure to set-up.

Operating through a partnership has similar **capital gains tax benefits** to that of a sole trader.

Partnership Agreements are essential for non-related parties. It is important that agreement is reached when setting-up the partnership about the respective time and financial commitments of the partners and on what basis and when they will be rewarded for their standard and above expected contributions. Agreements are largely “dispute settling” documents and it is vital to cover all potential areas of future dispute and to agree on the nomination of an independent third party arbitrator.

Legal liability and protection of personal assets is an area that partners should have a clear understanding of. Under partnership law, each partner is “jointly and severally” liable for the debts of the partnership. In the event of business failure, partners may bear the financial burden unequally – if one partner has tangible assets outside the business and other partners have nominal assets, the former can end up paying all the outstanding debts of the partnership.

COMPANY

Companies are **taxed entities**, and tax is paid on profits at the company rate of 30%. Under the imputation taxation system, company tax gives rise to tax credits, which enables tax benefits to be passed on to shareholders by way of franked dividends.

A company is the ideal structure when **unrelated parties** want to own a business together. It is the only structure to have if a person wants to grow the business to the point of listing it on the stock exchange.

However, the cost of setting-up and administering companies can be a stumbling block for small entities. Start-up costs can range from \$1000 up to \$1600 on top of which there are annual ongoing costs associated with share register transactions, recording of decisions via minutes, accounting and annual audit requirements as well as fees payable to the Australian Securities & investments Commission.

Unlike a partnership, which must cease when partners enter or leave the business, a company can continue no matter how often ownership of shares change.

A company is a **separate legal entity** and as such, the **personal assets** of the owner(s) are normally not at risk if the business fails due to unprofitable trading (exceptions: directors' personal guarantees; ATO directions for payment of outstanding PAYG withholding tax; and trading and debt creation when insolvent).

A company can employ the owners; extend cover via WorkCover insurance and make statutory employer superannuation contributions on their behalf. The business can also pay for motor vehicles on behalf of owners using the fringe benefits system.

A disadvantage for companies is the way in which **capital gains tax** is calculated as they do not receive the general 50% discount.

Nor do they receive the 50% discount applied to active assets such as goodwill or a business property. Although a company's significant shareholders do get the concession, the 50% discount of the capital gain must be paid out as an unfranked dividend. This is where it starts to get a bit complex – when this untaxed gain is distributed as an unfranked dividend, tax is paid on all the gain at the marginal tax rate of the shareholders. If this gain is treated as accumulated profit and is not distributed until the company is wound up, then the shareholders can get the 50% general discount, but they pay tax on this at their applicable tax rate.

Example:

Business is sold for a profit on goodwill of \$900,000

- business owned by a partnership of six individuals
CGT \$37,500 each ($\$900,000/6 \times 50\% \times 50\%$)
The partners could contribute \$37,500 each of the assessable profit to a super fund, so no tax would be payable under the retirement exemption.
- Business owned through a company by 6 individuals equally
CGT \$270,000 ($\$900,000 @ 30\%$) as no CGT small business concessions could be used

DISCRETIONARY FAMILY TRUST

Unlike a company, a trust is not recognised as a legal entity and does not have its profits taxed. Everything owned by a trust is held in the name of the trustee - can be one person or a number of people. It can also be a company and if legal liability is likely to be a problem (where individuals are trustees they are personally responsible for the debts of the trust) this is the preferred route.

A family trust is a tax-effective structure to operate a business through as it enables the business profit to be distributed among family members. The amount of tax saved by distributing to family members will depend on how many are over 18 (and not working) or working full-time in the business.

However, whilst this structure is one of the most flexible and tax-effective it comes at some considerable cost and involves a high degree of complication.

When a trustee distributes income to a beneficiary, it does not have to physically pay out the money. Often, the trustee simply draws up a minute that states how much of each year's profit is distributed to each of the beneficiaries. These distributions are recorded in the books of the trust as amounts owed.

As it is the individual beneficiaries of a family trust that pay tax on the income distributed to them, all of the CGT benefits are available to such a trust. The beneficiaries of the trust get this benefit, plus, as long as the significant individual test is passed (need to own enough units to entitle them to at least 20% of the income and capital distributions in the year the capital gain is made) all of the small business CGT concessions.

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