LEGAL OPTIONS FOR BUSINESS OWNERSHIP

Introduction

When purchasing or commencing a business, it is necessary to determine the most appropriate type of structure, considering all taxation and legal implications.

If you are starting out, you will need to register your business for taxation purposes, register your business or company name and, in some instances, obtain business licences and permits.

The most common business structures are:

- ✓ Sole Proprietorship
- ✓ Partnership
- ✓ Company
- ✓ Trust (whether discretionary or unit)

Sole Trader

This is a one-person business. You own and operate your business and your income and expenses are dealt with as part of your personal tax position. The business has no separate legal entity from the owner.

Advantages - This structure is simple and inexpensive to establish and administer. The nature of the business and the composition of its operation can easily be altered. There are no registration procedures other than GST and Business Name. There are fewer business regulations to comply with than for a company or a trust. Business Names legislation requires registration of any business name which is not identical to existing operators. There is a nominal cost to register a Business Name and it must be renewed every two (2) years.

Disadvantages - A sole trader has no separate entity from the business which means a sole trader has unlimited liability and is personally responsible for the business liabilities. The registration of a Business Name does not create a separate legal entity and as such does not limit liability in any way. Generally, there is no flexibility. A sole proprietor must receive all capital and revenue of profits and is accountable for them. Finally, a sole trader cannot share the burden of management and costs.

Partnerships

Partnerships are groups of two or more legal persons who associate in a mutual business enterprise with a view to make a profit and distribute the profits amongst themselves.

The partners can be individuals, companies or trusts. They are governed by either a Partnership Agreement which should be in writing (there is no legal requirement to do so) or a Partnership Act which implies various rights and liabilities into the Agreement.

Advantages - Unlike companies a partnership has no formalities, registration or reporting obligations other than taxation returns. The partners may agree to withdraw their capital at any stage. Some professions have prohibited incorporation, in which case a partnership is an appropriate form of association.

Disadvantages - Partners have unlimited liability which means that their personal assets are liable if the Partnership's assets are insufficient. If one partner will not or cannot pay his share of a partnership liability, then the other partners must do so personally, jointly and severally. A partnership exposes personal assets to any partnership liabilities. Partners pay personal tax and can be sued personally for anything done in the name of the Partnership. Generally, there is limited flexibility in terms of distribution of profits, because profits are distributed in accordance with the terms of the Partnership Agreement.

Company

The Australian Securities and Investments Commission (ASIC) is the federal government body which administers Company Law.

Advantages - A Company is a separate legal entity and once created is an entity in its own right. It has a legal personality to do what a natural person can do. Therefore, a Company can sue and be sued. A Company officer is generally not liable for trade debts unless he personally guarantees the debt. A shareholder's liability is limited to the paid value of their share (though a Company can call up any unpaid amount). This means a creditor cannot gain access to the assets of the shareholders. A Company has continual existence. Transferring of ownership is simply transferring shares in the Company to someone else. The Company can make contracts with shareholders since they are separate (often to inject additional funds into the business).

Disadvantages – Companies are highly regulated through the Corporations Law (Cth); Trade Practices Act (Cth) and various other Commonwealth and State Acts. Greater regulation and penalties result in more time in ensuring accuracy and accountability in registers, accounts and annual returns. Application of the Corporations Act is expensive and onerous. A Company is a more expensive start up and requires an annual fee payable to ASIC. This does not include accounting, corporate secretarial or legal fees. There is always a possibility of personal/director guarantees to banks, landlords, suppliers or other third parties. Companies have less privacy; the ASIC, members and the public can search company records. Onerous Directors Duties apply.

Trusts

A Trust is composed of three (3) parties, the Settlor who creates the trust by drawing up a deed and entrusts property or money to a Trustee, the Trustee who then manages the property or money, and thirdly the Beneficiaries, who receive the benefit of the capital and income of the Trust. The Trustee and the Settlor are in a contractual relationship. The Trustee is in a fiduciary relationship with the Beneficiaries.

Discretionary (Family) Trusts – Generally established for the benefit of a family and its members. It allows the Trustee discretion as to the distribution of both income and capital, to Beneficiaries who can be both specified in the Trust Deed and general.

Advantages – The Trustee has decision making power which is at his discretion. This is in contrast to Unit Trusts where the Trustee has less real decision-making power. Flexible, because profits are distributed in accordance with the Trustee's discretion.

Disadvantages - A Trust must be run according to the rules of the Trust Deed, though the common law of Trusts will imply many rules. A Trust has no separate legal entity from the Trustee; the Trustee is liable for all the liabilities of the Trust. Because the Trustee is personally liable, a Trustee may be a Company with Limited Liability so that the personal assets of the Manager are protected. Onerous Trustee Duties apply.

Unit Trusts - A Unit Trust is usually a trading trust where capital is divided into Units, each Unit Holder owning Units according to their contribution, like shares. A Trustee invests the money into a business venture and the profits are then paid back to the Unit Holders who are the beneficiaries of the Unit Trust, like shareholders receiving dividends. The Unit Trust is run according to a Trust Deed. The investors are initial 'settlors' who contribute capital to a fund; the Trustee is usually a Company which appoints a manager to invest the funds.

Advantages - The Trustee has Limited Liability. Unit Holders can pool their small amounts of capital to achieve a viable investment. Unit Trusts are means of spreading the risks of an investment. A Unitholder owns Units which are usually readily transferable and can be sold, like shares. Unit Holders directly own the property of the Trust. Unit Holders can wind up the Trust.

Disadvantages - Unit Trusts have some disadvantage in that they are only as good as the way they are managed. A Unit Trust may have a Deed which allows for shortfalls to be paid by the Unit Holders. A Unit Holder might lose all their capital as well as their earnings. Unit Trusts are limited in flexibility because profits are distributed in accordance with the fixed percentage outlined in the trust Deed (although this is now avoidable with 'Hybrid' Unit Trusts, which allow income to be distributed at the discretion of the Trustee, like discretionary trusts above).

Conclusion

Buying or operating a business is exciting and involves risk. The structure of ownership behind a business and cost of establishing it are important.

Whether as a buyer or seller, it is strongly recommended business advisers including accountants and lawyers are involved in the process, to ensure rights and obligations are respectively protected and honoured. Significant Director and Trustee Duties may also be relevant depending on your preferred structure.

If you require further advice in relation to the above or Property, Franchising, Leasing, Trademarks or Commercial or Corporate Law, please contact us.

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