Department of
**Primary Industries and**
**Regional Development**

GOVERNMENT OF
WESTERN AUSTRALIA

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# Legal and **business structures**

The Investor Readiness Program is an initiative of the Department of Primary Industries and Regional Development delivered in collaboration with BDO Australia.

**Disclaimer**

# Is your legal structure right for **capital raising?**

You may have a business that is already operating or have a brilliant idea for a new product, service or innovation. Before you consider raising capital, you need to consider if your legal structure or prospective legal structure is suitable for the future growth of the business and for attracting investors.

The following outlines some of the common business structures and considerations when choosing a business structure and challenges that exist in obtaining investment.

## Common business structures

The following structures are commonly used when operating a business:

- sole trader
- partnership
- company
- discretionary trust
- unit trust.

You want your structure to be able to transition through the growth stages of your business, rather than having to change it on a regular basis.

## Key considerations for choosing a structure

Each structure has unique characteristics which need to be considered prior to the incorporation. When choosing the ideal structure, your considerations should include:

### Tax planning

The legal structure chosen will have significant effects on the amount of tax you pay. Essentially, you want your structure to work for you to allow flexibility in your tax planning and optimise the amount of tax paid. The tax rate for companies (27.5% to 30%) is usually an attractive incentive over the marginal tax rates of individuals (which can be up to 45%), however, there are various tax laws to deter shareholders from removing funds from the company.

These laws need to be taken into consideration, rather than the face value tax rate. Structures like sole trader and partnerships do not allow for any flexibility in tax planning as the rates are set at the individual's marginal rate. This makes them a less attractive option for medium size businesses.

### Limitation of liability

Limitation of liability (asset protection) refers to the extent you are personally protected from liability. Partnerships and sole traders hold a high level of personal liability, making them relatively unattractive structures from this standpoint.

Companies provide a high level of protection from personal liability for shareholders and directors, however, there are some situations where a director may be personally liable.

### Flexibility and future needs

Things to consider in your future needs are:

- Is this structure easy to exit in the event of a sale?
- Will this structure be easy to incorporate new investors into the business?

Partnerships and sole traders generally do not allow for easy transition and growth and may impact the ability to bring in new investors. Unit trusts and companies may be a more attractive options for businesses looking for future investors.

### Control

The level of control an owner has will vary depending on the structure chosen. For example, trusts and companies have trustees and directors who are responsible for the control of these entities whereas sole trader or partnership structures enable full control.

If you choose a trust or company structure and would like to ensure you have greater control, this can be done by appointing yourself as a trustee or director, however you will need to understand the requirements and responsibilities involved in these roles.

### Administration and cost

Administration and cost may be of less significance than other factors when choosing a business structure. Companies and trusts usually require more administration and cost to operate than sole traders and partnerships, however, the advantages in the other characteristics may outweigh the disadvantages.

## Changing your legal structure

If you review your business structure and decide it is not optimal for the future of your business or incoming investors, you have the ability to change it.

Changing a business structure may have potential tax implications such as the sale of an asset that may create a capital gains tax liability. The Australian Taxation office (ATO) may offer rollover relief which may reduce or eliminate any tax payable. Before proceeding with a change of business structure you should seek the advice of an accountant.

Some of the impacts of changing a business structure may include transferring:

- employee contracts, supplier and customer contracts
- any intellectual property (brand, business name and similar) to the new entity
- property, and plant and equipment which can result in stamp duty or capital gains implications.

## Asset protection for growth

Protecting the assets in your business is essential when becoming investor ready. Assets should be protected in the event your business faces legal action, or another event which could jeopardise the asset. Different types of assets can be protected in different ways through legal structuring.

When expanding your business, it is necessary to consider if you need to create an extra layer of protection for your intellectual property. Such protection could include separating the ownership of the intellectual property into another entity.

Plant and equipment can form a large portion of a business' assets and therefore may need protection from potential business risk. It is important to consider whether the ownership of these assets will remain in the same entity as the business with no agreements, or whether agreements around ownership will form the contract.

Land and buildings may also be an important consideration if the business or the business owners own the property from which the business operates. If the land and buildings are owned within the business, you may want to consider separating this out from the business structure.

Aside from ownership of land and buildings, other considerations include:

- market value rent to be paid
- ease agreements.

## Legal structure chart

| | SOLE TRADER<br>An individual, as the exclusive owner of the business, trading on their own. | PARTNERS<br>People, companies and/or trusts running a business together (not as a company). | COMPANY PTY LTD<br>A legal business entity owned by shareholders and operated by directors. | DISCRETIONARY TRUST<br>Trustees (people or companies) operating a business for beneficiaries who receive discretionary amounts. | UNIT TRUST<br>Trustees (people or companies) operating a business for set beneficiaries entitled to set amounts. |
|---|---|---|---|---|---|
| Separate legal entity | ✗ | ✗ | ✓ | ✗ | ✗ |
| Controlling party | Individual | Partners | Directors of company | Trustees | Trustees |
| Control over assets | Absolute | Joint | Separated | Uncertain | Collective |
| Exposure to liability | Unlimited | Unlimited as well as joint and severally liable | Limited liability | Limited - subject to trust deed | Limited - subject to trust deed |
| Compliance costs | ★☆☆☆☆ | ★★☆☆☆ | ★★★★☆ | ★★★☆☆ | ★★☆☆☆ |
| Asset protection | ★☆☆☆☆ | ★☆☆☆☆ | ★★★★☆ | ★★★★☆ | ★★★★☆ |
| Flexibility | ★☆☆☆☆ | ★★★☆☆ | ★★★★☆ | ★★★★★ | ★★★★☆ |
| Complexity | ★★☆☆☆ | ★★★☆☆ | ★★★★☆ | ★★★★☆ | ★★★★☆ |
| Saleability | ★☆☆☆☆ | ★☆☆☆☆ | ★★★★★ | ★★★☆☆ | ★★☆☆☆ |
| Ability to obtain finance | ★★★☆☆ | ★★★★☆ | ★★★★☆ | ★★★★☆ | ☆☆☆☆☆ |
| Tax rate | Individual marginal tax rate | Partners marginal tax rate | Company rate 27.5% - 30% | Beneficiaries tax rate | Beneficiaries tax rate |
| CGT discount | ✓ | ✓ | ✗ | ✓ | ✓ |
| Pros | Simplified and cheapest entity to establish | Minimal cost to set up and relatively easy to operate | Limited liability and good finance raising potential (equity and debt) | Flexibility to distribute income to maximise low tax rates | Limited liability while having set unit holder ownership |
| Cons | Little to no asset protection as unlimited liability in own name | Unlimited liability including joint and several liability | Cost of setup and limited tax concessions | Losses cannot be distributed out | No ability to distribute income to anyone other than unit holders |

## Director liability considerations

As a company is a separate legal entity, there must be at least one director acting on behalf of the company. In becoming a director, you agree to act in the best interests of the company, shareholders, employees and creditors. This is called ‘duty of care’ or ‘fiduciary duty’. This responsibility is not to be taken lightly, as the obligations commence once the company is registered or you are appointed and continues until you resign, or the company is deregistered from Australian Securities Investment  Commission (ASIC).

Usually, as a director, you are not personally liable for the debts and obligations of the company. This means that if the company cannot pay its debts, or a creditor takes court action, only the company’s assets are at risk, not the director’s personal assets.

There are some debts incurred by the company that the director needs to ensure are paid, otherwise a director may be personally liable. These obligations include any:

- Pay as You Go (PAYG) withholding debt owing to the ATO at the due date
- superannuation guarantee payment for employees’ superfunds outstanding at the due date.

If you are a shareholder of a company who is also a director, you should ensure you have internal processes in place to identify any outstanding PAYG withholding and superannuation.

## Tax considerations

Capital Gains Tax (CGT) events are different types of transactions or events that may result in a capital gain or loss. For example, the sale of shares is a CGT event. In the event the capital raising process is structured so that a capital gains event occurs, you will need to consider the tax implications.

There are various tax laws around concessions allowed to be applied to a CGT asset, which, if structured effectively, can reduce the tax payable. One of the most beneficial CGT concessions is the small business CGT concessions.

For eligible taxpayers, the small business CGT concessions available are:

- 15-year exemption
- 50% active asset reduction
- retirement exemption
- rollover.

If the business is eligible and structured correctly, you can have potential significant tax savings. In this case, it is advisable to review your structure with your accountant on a regular basis to consider whether you are eligible for these concessions.

## The Department of Primary Industries and Regional Development is ready to assist you

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