Business structures explained

Sole trader
If you trade, control and manage all aspects of your business individually you will be classed as a sole trader. You may have employees but the full control of your business rests with you. It is a very simple business structure. The benefits of being a sole trader are:

- there are very few legal and tax formalities involved in setting up the business;
- the structure is inexpensive to set up;
- you have full control of the business and own all the assets;
- you receive the full benefit of profits made by the business, which makes for simple operation of farm management deposits and income averaging;
- you keep all the after-tax gains if the business is sold.

What to watch out for when operating as a sole trader:

- your access to finances may be limited to your own resources;
- your ability to minimise tax is limited;
- you are legally and personally responsible for all aspects of the business;
- debts and losses cannot be shared (no partners);
- you can lose private assets such as your home, contents and vehicles if the business becomes unviable. There is little asset protection.

Partnerships
In many ways the partnership is the next logical step from the sole proprietor. A partnership is a relationship between people who are 'carrying on a business in common with a view of profit'.

As a business structure, a partnership is simple, flexible and, if properly set up, an effective arrangement. Whether it suits your business needs will depend on your circumstances and requirements. Partnerships can have up to 20 people and their operation is governed by the Partnerships Act. The partnership should be documented in a formalised partnership agreement.
The benefits of a partnership are:

- it is a simple structure both legally and financially;
- it has flexibility – many of the provisions of the Act can be changed to suit your particular needs;
- that each partner can bind the other partners in contract;
- the partnership pays no tax though it must still lodge a tax return;
- the profits are shared among partners in the proportions they decide and each pays tax on their share at the personal rate;
- no special partnership reports or returns other than a partnership tax return are required;
- it only has to be registered if its official name is different from the names of the partners;
- capital gains concessions are possible upon sale of assets.

What to watch out for when operating as a partnership:

- the liability of the partners for the debts of the business is unlimited, as it is with sole proprietorships;
- each partner is 'jointly and severally' liable for the partnership's debts (i.e. each partner is liable for their share of the partnership debts as well as being liable for all the debts);
- sometimes the law can decide that a partnership exists even though you haven't intended to form one;
- if partners join or leave, you will probably have to value all the partnership assets, which can be costly;

- if partners join or leave, the Taxation Office treats the partnership as having terminated and requires a special tax return to be lodged;
- you must share the profits with the other partners;
- you can lose private assets such as your home, contents and vehicles to settle debts of the partnership;
- without a partnership agreement, partnerships can be difficult to dissolve.

Joint venture
This is a variation of the partnership and unless this arrangement is very carefully documented and carried out, it may be considered that a business is being carried on in common so that a partnership may be deemed to exist. This would then give rise to all the usual rights and obligations of partners. The distinguishing features of a joint venture include:

- that each party contributes something, often in kind;
- the results of the activity undertaken together are withdrawn in kind, not in profits after a sale of whatever is produced and the payment of related expenses.
- Joint ventures can be very useful in appropriate circumstances, for example, they may allow land development to occur while retaining the actual land on capital account and also allowing development expenses to be deducted as incurred.

Company
A company is a more complex business structure. A company is a distinct legal entity that is regulated by the Australian Securities and Investment Commission (ASIC) through the Corporations Act. There are 2 types of companies - private (Pty Ltd) and public (Ltd) which are listed on the ASX

A private company is a common business structure. Ownership of the company is through shareholding, which gives the owners of the shares rights to a defined percentage of the company. There can be different classes of shareholding which give different rights.

The benefits of forming a company are:

- your liability for the company's debts is limited - shareholders are not liable for the debts of the business (limited liability) which gives increased asset protection;
- changes in membership do not affect the company (this is called perpetual succession);
- members can be employed by the company;
- taxation rates are more favourable (though you will have to consult your accountant about whether this provides an overall benefit to your business);
- that a company pays tax on its own profits at a flat rate.

What to watch out for when operating as a company:

- it is more expensive to establish;
- it is regulated by the Corporations Act;
- the reporting requirements are far greater than for sole traders and partnerships;
- individual shareholders have little say in the running of the business as decisions are made by all shareholders;
- access to capital gains concessions, income averaging and farm management deposits can be more difficult.

Trust
A trust is one of the most complex structures, mainly because it is not even recognised by law as a legal entity. It can be defined as a legal obligation binding a person (the trustee) to deal with property of others which he/she has control (trust property) for the benefit of persons (beneficiaries). Each of these parties, as well as some assets, must be identified (or identifiable) before a trust can exist.

Trusts may be established by a document known as a trust deed (an express trust) or by conduct (an implied, or a resulting trust), court order or legislation (constructive trusts).

Because a trust is not a legal entity as such, most legal dealings are with the trustee. It is the trustees who control the assets. Provided the trustee complies with the terms of the trust deed and applicable law, they are entitled to deal with those assets as they see fit. In particular, and subject to some exceptions, it is **not** open for a beneficiary, or potential beneficiary, to direct the trustee on what it must do with the trust fund. Further, the assets belong to the trust and not to the beneficiary.

A further complication with trusts is that there are different types which have been tailored to numerous purposes, and in some cases they are uniquely appropriate. Essentially, however, there are only a limited number of major variations.

Unit trusts
Unit trusts are the easiest to understand as in many ways they are like companies. Instead of owning shares a person holds units. Many of the major group investments and managed funds are conducted as unit trusts. The right to income and capital from the trust is pro rata depending on the number of units held as a share of the total number of units issued.

Discretionary trusts
Discretionary trusts are a little vaguer, but essentially permit the trustee to choose between different beneficiaries when it comes to distributing funds. That choice, or discretion, can, subject to the wording of the constituting document, change as often and in such manner as the trustee chooses. There are usually no fixed entitlements to income or capital. Obviously, this sort of structure usually only has appeal in a family context. They are also known as family trusts, but they can be useful outside the context of a family.

Hybrid trusts
Hybrid trusts are really just a combination of unit and discretionary trusts. Usually they involve several families who are involved in the business. Each family has its own discretionary trust, and each family trust owns a fixed entitlement in a unit trust that owns the business. In that way, each family has a fixed share of the business and its profits, but discretionary distributions can be made between the members of a particular family. Although having the features of both a unit trust and a discretionary trust can be attractive, these can be very complex to administer and even more complex to change or restructure. It is preferable to avoid them if possible.

Testamentary trusts
There are at least 3 different types of testamentary trusts:

- Those expressly set up under the will itself. These are the ones more often referred to and are usually intended to continue for some time after the estate administration has been completed. In many ways these are a subset of discretionary trusts, but with some important modifications designed to take advantage of tax concessions available on death. Care must be taken that advantages that may have been available on death are not actually lost because of the use of a testamentary trust.
- Those that usually arise or are created as a result of the will's provisions. These will include a temporary trust at least, while the executor, as trustee, goes about putting the will's instructions into effect for the beneficiaries.

- It is also possible for the beneficiaries to create a trust with the asset/s received. If appropriately established, these may enjoy similar taxation concessions as the more commonly recognised testamentary trusts. However, there are some additional limitations to those which would apply to the usual testamentary trust. In particular, they must be set up within 3 years, the capital in the trust must rest ultimately in the income beneficiaries and the income that can be passed through such a trust is limited. Because of some unique features of the Succession Act in NSW, such trusts are effectively no longer possible in that State.

Superannuation funds
Superannuation funds are essentially trusts. They may enjoy special taxation concessions if they comply with strict legislative guidelines on their establishment, activity, purpose and financial dealings. Being a trust, the members do not own the assets in the fund. Instead, provided the trustee/s deals with those assets in accordance with applicable legislation and the trust deed, the individual member has few rights against the trustee.

In particular, the trustee is not bound by the terms of a member's will and so, subject to any part of the deceased member's estate. Superannuation may itself be classed into either:

- self-managed superannuation funds; or
- other funds, usually having an APRA approved trustee - these include retail funds, company funds, industry funds, defined benefit and public sector funds
- Not only can these entities be combined in all sorts of interesting ways, but it is often necessary to have several or more, sometimes of the same type, in order to satisfactorily address what is needed. So there can often be multiple entities for multiple purposes.

For more information, download superannuation and pension funds

One structure or entity is suitable for all, or even most, purposes. All combinations have strengths and weaknesses with varying degrees of relevance to a particular situation. Every person and their needs and aspirations are different and therefore so too is the entity or structure that bests suits them. **Seeking professional advice is important to choose the structure most suitable to each business.**

Further information
Download our business structure table that explains the different taxation and legal effects of a business structures

Australian Taxation Office has several articles giving a brief description of both a sole trader and of a partnership, including the tax reporting obligations

Commonwealth Bank has good information on business structures

Rural Law Online has some excellent information in plain language.