What I need to know about Setting up of new business

TOWNSENDS BUSINESS
& CORPORATE LAWYERS

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What is a business?

To fully understand the legal issues that relate to small business, you must be crystal clear on what a business is and, just as importantly, what it is not.

A 'business' is essentially the selling of goods or services for the purpose of making a profit.

It is vitally important to distinguish between the business itself and the legal structure used to run the business (for example, a partnership, company or trust). We'll review ownership structures later in this guide.

A business can be only one of a number of assets the business owner owns. For example, a company can own and operate a business and at the same time own real estate that has nothing to do with the business. In this case, the business and the real estate are each simply part of the company's assets.

On the other hand, the term 'business' can be used to describe all the assets used in the business – but only when all those assets are used for the same purpose: the sale of some product or service that is sold in order to make a profit.

Each component of the business may have different legal and tax consequences associated with it.

When we talk about the various assets that make up a business we do not only mean the tangible assets – the things you can see and touch. We also mean the intangible assets – the rights, relationships and even obligations that the business operator needs to effectively operate the business.

Sounds a bit complicated? There is no substitute for specific advice applicable to your particular circumstances, but with the help of this guide you can at least become familiar with the steps to make informed business decisions.

The components of a business

The typical components of a business usually include some or all of the following:

- business name and perhaps trademark
- right to occupy premises (eg. a lease)
- plant and equipment
- fittings and fixtures
- stock (raw materials and unsold finished products)
- goodwill
- telephone number/s
- employees
- supply agreements
- unfilled orders and work-in-progress
- registered designs, patents, and licences
- statutory licences used in the business (eg. liquor licence in a hotel)

A business can also be bought and sold. The owner can transfer to the buyer all the physical assets and other rights, relationships and obligations that are used to produce the business product or service. The owner must be able to legally transfer all of these aspects of the business to the successful buyer before putting it on the market. The buyer must be in a position to accept that transfer and ensure the efficient and profitable running of the business before it is bought.

What is the difference between a legal entity and a business?

Legal entities can sue or be sued in their own name. They include individuals, companies and government.

A business is not a legal entity. A business is just one of the assets of the owner of the business. It therefore follows that every business must be owned by a legal entity and it is that entity which may sue or be sued as a result of an issue arising out of the operation of business.

The legal entity (person or company) which owns the business has legal rights, powers, privileges, immunities, liabilities and disabilities. For example, the owner of the business (person or company) can be sued if the business incurs a debt (or any other liability).

If the business is owned by a partnership, each partner is individually liable for the whole debt or liability of the partnership.

How to choose the legal entity to run your business

What entity should you choose to operate your business? Will you operate it in your own name? Through a company? A partnership? A trust? Before assessing the available choices, consider what you are hoping to achieve by selecting a particular structure. Here are the main criteria.

Set-up costs

These are the initial costs of establishing the structure for the business and of maintaining that structure. What are the financing requirements and how is any required security to be provided? When start-up cash is scarce, do you really to spend over $2000 setting up a discretionary trust with a corporate trustee? Eventually, when the success of your business is more assured, that money will be well spent. But you may not need to spend it right at the start.

Distribution flexibility

This is the ability to allocate income and/or capital among the various owners or their families at any time in the way you choose. This could involve income-splitting with other members of the family for tax purposes or to safeguard the interests of a disadvantaged family member (eg. a person who is bankrupt, going through a divorce or incapacitated). It could also involve streaming certain types of income to certain owners with an advantageous result.

Asset protection

This relates to the ability to protect your personal assets if the business fails. Ideally, you would want your liability to creditors to be quarantined to just the business's assets – and sometimes not even these. You may also want to protect the interests of disadvantaged family members mentioned earlier. Structuring the business to protect your assets as much as possible is therefore important.

Tax minimisation

This is the ability to make best use of tax benefits such as:

- capital gains tax concessions
- income-splitting to access personal marginal tax rates
- depreciation
- tax losses
- lower tax rates (eg. corporate rate)

The choice of structure will influence your ability to access these beneficial tax rules. For example, there are a number of highly beneficial capital gains concessions for small business which need to be carefully considered when choosing the structure of your business. A capital gain would be made if your business changed ownership or your interest in the business ended, or changed. If that gain was attributable to the goodwill of the business, you may well be able to benefit from capital gains concessions.

These concessions may include:

- only 50% of the capital gain being assessable for tax
- a tax exemption for active business assets owned for more than 15 years
- a further 50% reduction for active business assets
- a retirement concession allowing up to $500 000 to be put towards retirement benefits
- a rollover concession for active business assets sold and replaced

The overall effect of these concessions is that a taxable capital gain in respect of your business may, in the right circumstances, be substantially reduced.

To be eligible, the maximum net investment and business assets of the small business owner and related entities connected with that owner must not exceed $6 million. The way you structure your business and the entity you choose to operate it, could affect its eligibility. This must be kept in mind when setting up the business.

Available structures to run your business

What entity should you choose to operate your business? Once you have worked out your priorities in terms of what you want to achieve, you can properly assess the following potential choices.

Individual

You can simply own a business in your own name and have total control over it. The business is then just another of your assets like your house, car or golf clubs. This is the simplest and the cheapest way to set up a business (which may be important in the early days). Although you will be able to access the capital gains tax concessions, there is no facility for income-splitting and all your personal assets are available to the business's creditors if things go wrong.

Partnership

If more than one person owns the business, you may own it as a partnership. Partners are 'jointly and severally' liable for partnership debts. A creditor can call on one partner to pay the whole of the partnership debts. That partner will then seek recovery of the funds from the other partners. A partnership can comprise individuals, companies or trusts. Subject to the partnership agreement, each partner is entitled to take part in the management of the business. The taxable profit is distributed between the partners who add it to their personal assessable income.

Company

A company is a separate structure whose owners own shares in it. The company is treated like a 'virtual person' for commercial purposes.

The advantages of a company are:

1. the owners (shareholders) are generally not liable for the company's debts so their personal assets are protected
2. the company enjoys a much lower tax rate than individuals (albeit without access to marginal tax rates)

The disadvantages of a company are:

1. relative inflexibility in the distribution of income
2. inability to access some tax benefits, including the 50% capital gains tax discount referred to earlier
3. running expenses including annual filing fees, accounting fees and compliance costs under the Corporations Act

Trusts

Unlike a company, a trust is not a legal entity but rather a relationship between the person that holds the property (the trustee) and the person ultimately entitled to the property (the beneficiary). It is the trustee who holds the property and operates the trust who is the legal entity acting for the trust.

The advantages of trusts include:

1. longevity, where the assets held within the trust are part of an entity which will last beyond the lifetimes of the individuals involved
2. the facility to split income among a range of beneficiaries who may not be paying tax at the top marginal rate
3. significant asset protection for those controlling the structure if the trustee is a company

There are two main types of trust:

- Discretionary trust where the trustee can decide at any time who among the beneficiaries will receive income or capital. This distribution flexibility is a significant advantage. The beneficiaries only have the right to be considered by the trustee and cannot demand any share of income or capital from the trust. The most common type of discretionary trust is the family trust where only specific members of the defined family are entitled to receive distributions without attracting higher tax rates.
- Unit trust where the beneficiaries hold 'units' or fixed shares in the property (capital, income or both) of the trust.

Discretionary trusts are used by a person wanting to share the benefits of the trust with their family. Unit trusts are used where several co-owners wish to operate the business together and distribute the income of the business to each co-owner who can then share it with their family via the discretionary trust that owns the units in the unit trust.

Trusts are not good vehicles to utilise tax losses. In addition, both major political parties have been considering amending the tax rules relating to trusts and limiting their tax effectiveness. The future tax status of trusts therefore cannot be guaranteed.

In summary

The important lesson in all of this is to take into account your specific situation and requirements, understand the likely current and future tax consequences of your choice of structure and get yourself a good accountant and lawyer.

When you are setting up your business, its structure should ideally be flexible enough to minimise costs and protect your assets. Your chosen structure should also be flexible enough to accommodate your changing circumstances with the least effect on you.