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## BUSINESS STRUCTURES - TYPES & ISSUES

### Business Structures - Introduction

“Business structure” is the legal term used to describe the entity through which a business conducts its activities. The choice of a business legal structure is an important business decision as the structure of a business determines how a business is treated by the law, which in turn impacts upon the conduct of a business and ultimately its success.

In Australia, the major forms of business structure may be grouped into the following categories:

- Sole Proprietor / Sole Trader
- Partnership
- Company
- Trust.

Sometimes, a combination of the above is used.

### Business Name

A Business Name is the name under which a sole proprietor, a partnership, a company or a trust chooses to trade. In WA, the Business Names Act 1962 requires the registration of all Business Names under which business is carried on from premises within Western Australia. The only exception to the requirement for registration is where the business is carried out in the personal name of the person carrying out the business.

### Business Name vs Business Structure

Unlike the business structure, the Business Name does not have legal consequences beyond its use as a mean of identifying a business. A Business Name is not a legal entity:-

- It cannot incur or have legal rights or obligations,
- It cannot enter into contracts in its own name;
- It cannot sue or be sued; and
- It cannot own assets.

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## **Business Names Hint**

If you want to know whether a particular name is already being used in your State, you may do a preliminary search through the National Names Index at the Australian Securities and Investments Commission website at <http://www.search.asic.gov.au/gns001.html>.

## **Sole Trader**

A Sole Trader, sometimes referred to as a Sole Proprietor, is a person who carries on a business directly as an individual without any additional formal legal structure. The business carried out is owned and controlled directly by that single person, the Sole Trader.

This is the simplest, cheapest and most easily administered form of business structure. It is relatively simple to set up and does not require the formalities involved in setting up a Partnership, a Company or a Trust. The Sole Trader may trade in his/her own name or a Business Name may be registered. There is no distinction between the ownership of business assets and private assets and many sole traders use them interchangeably.

With a Sole Trader, the profits from the business activity pass directly to the owner (the Sole Trader). At the same time, all business debts and liabilities are also the responsibility of the Sole Trader. This means that if claims are made against the business, (for example, by financial institutions, suppliers, customers etc) and the business is not able to pay all of those claims, these people may take legal action and recover their claims, not only from the Sole Trader's business assets but also from the personal assets of the Sole Trader.

## **Advantages and Disadvantages of the Sole Trader as a business structure**

The **advantages** of the Sole Trader include:

- Cheap & easy to set up
- Relatively cheap and easy to operate
- Simple to understand

The **disadvantages** of the Sole Trader include:

- Personal liability of the Sole Trader (business debts may need to be paid from the personal assets of the Sole Trader)
- Limited capital raising ability (because the Sole Trader is by his/her very nature a "one man/woman show", there is no pooling of assets and the Sole Trader has only his/her own personal assets to draw on for fundraising purposes)
- Inability to Split Income with others

## **The Other Forms of business structures**

The other forms of business structures are dealt with in separate handouts.

## **Choosing the business structure**

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The form of business structure used to carry out a business should be chosen carefully and thoughtfully. Although not irrevocable, the ability to switch between different types of business structures as the business changes may be limited. Before a change of business structure is made, it is highly recommended that legal advice is obtained.

When choosing the most appropriate business structure for a business, there are a number of considerations which are often taken into account. Note that there is no one choice that fits every business. Sometimes, the choice made may become inappropriate over time where the nature of the business enterprise has changed. Below are several of the most important factors involved in choosing the appropriate legal structure for your business. These include:

### **1. Cost of Formalities and Administration**

A Sole Trader and a Partnership are easily set up and therefore the cost of setting up will be relatively low. In contrast, Companies are much more expensive to set up and run as they are very highly regulated business structures. Business owners who are just starting out often prefer to spend as little as possible on the legal structure of their business. For them, it can make more sense to form the simplest type of business - a Sole Trader or a Partnership. However, as their business expands or takes on more risky activities, a Trust and or a Company may become more appropriate.

### **2. Risks and Liabilities**

Often, the structure of a business depends on the nature of the business. If the business engages in risky activities, the Sole Trader and Partnership form of business structure may be inappropriate as the owner/s are personally liable for the debts and obligations of the business. In such situations, personal liability/asset protection may be called for and incorporation may be the best choice.

Traditionally, one of the greatest advantage of the Company as a business structure is its ability to limit the liability of the owners for the debts of the business. However, in practice, this advantage (at least for small business where the owners and shareholders are often the same people) has been reduced by the practice of requiring directors to give personal guarantees for loans and overdrafts from financial institutions and also by the corporate governance rules which allow for the possibility of directors being made personally liable in certain situations. However, this does not diminish the fact that the Company as a business structure does offer personal liability/asset protection for its owners. This is especially true where the business is seen as an investment and the person investing will not be a director. In such situations, the personal liability protection afforded is substantial.

### **3. Control & Management**

A Sole Trader is able to maintain a high degree of control over the business enterprise. However, where a number of people are involved in the ownership of a business, there may be times when their business objectives differ. For example, while certain people are interested in the management of a business, there will be others who are only interested in the return on their investment. In such situations, the control and management issues will need to be taken into account in the structuring of the business.

#### **4. Legal Limitations**

Sometimes, there are legal limitations in the form of business structure that a business may use depending on the industry in question.

#### **5. Financing**

Some business activities require a high level of capital to establish and operate. It may be that there is a need to attract investment and/or capital. In such a situation, it may be that the most appropriate business structure is the Company. The Company is probably the most effective fund-raising business structure.

#### **6. Taxation**

As there are different tax treatments of the various business structures, taxation issues are often a major factor in determining the form of business structure.

For example, the Sole Trader and the Partnership as forms of business structures are treated as “pass-through” tax entities, which means that all of the profits and losses pass through the business to the owners, who report their share of the profits (or deduct their share of the losses) on their personal income tax returns. This means that the owner/s of a Sole Trader or Partnership pay income taxes on *all* net profits of the business, regardless of how much they actually take out of the business each year. Even if all of the profits are kept in the business bank account to meet future business expenses, the owners must report their share of these profits as income in their tax returns.

In contrast, the owners of a Company do not report their shares of corporate profits on their personal tax returns. The owners pay taxes only on profits paid out to them in the form of salaries, bonuses and dividends. The Company itself pays taxes, at special corporate tax rates, on any profits that aren't deductible -- that is, profits that are left in the Company from year to year (called "retained earnings") and dividends (portions of profits that corporations sometimes pay out to shareholders in return for their investments). This separate level of taxation adds a layer of complexity to paying taxes, but it can be a benefit to some businesses. However, this is a complicated area of the law and it is highly recommended that expert advice is sought.

#### **7. Termination and/or Sale**

Some business entities automatically terminate upon such events as the death and/or withdrawal of an owner. Sometimes, this may be the desired result. However, if it is envisaged that the business is to continue after the death of an owner, some planning at the business structure stage may be appropriate for ease of ownership transfer. Similarly, certain business interests are easier to sell than others. For example, a partnership interest is often not easily sold as it requires the approval of the other partners.

#### **8. Business Expansion**

Most entrepreneurs want to be as successful as possible. Some business entities are limited in the number of owners they may have. A Sole Trader ceases to exist the moment the Sole Trader takes on a partner. It is important to choose a business form that allows the greatest flexibility in accordance with what is planned for the business.

Although the business structure may be changed when it is no longer appropriate, this may involve additional expense and be potentially disruptive.

### **Hints for Choosing a business structure**

**DO** know the tax and personal liability consequences of a business structure before making your choice.

**DO** develop a business plan. Your business plan may dictate the options you have in choosing a business structure.

**DO** consider your personal and family considerations before making a choice.

**DO** ask your professional advisor if something doesn't make sense. Your professional advisor works for you, and should help you understand every part of the business start-up process.

**DON'T** begin operating your business before determining its form. Operating as a Sole Trader with the intention of forming a Company will not shield you from being personally liable for any obligations or debts prior to the formation of the Company.

***DON'T** panic. Choosing the most appropriate business structure can be complicated. Your lawyer can make sure that you choose the business structure that best suits you.*

### **Butlers**

At Butlers we pride ourselves on being “The Personal Law Firm”. Our commitment at Butlers is to make the law more accessible, affordable, understandable and human. We aim to reduce your concerns by speaking and writing in plain English, cutting through legal jargon and keeping you informed at all times. Through it all, we work closely with your family’s accountant, bank manager, financial adviser, and other professionals as required. We therefore encourage you to contact us if we may be of any assistance.

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