practice DNA

The essentials of setting up, building and running your practice.

Episode 7:

Business Structures for your Practice

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Hi, I am your host Matthew Holmes and this is Episode 7 of Practice DNA, the podcast that helps you set up and run your own practice. Today I am really privileged to be interviewing Shane Macfarlane from liveaccountants.com.au. So let us get straight into it and get into the interview.

Matthew: I am very pleased today to be able to interview Shane Macfarlane from Live Accounting at liveaccountants.com.au. Shane is a former partner at a Business Review Weekly top one hundred accounting practice and established Live Accounting after spending some years abroad working for MYOB Accounting Resourcing. You have worked with many practitioners over the years and helped them grow their business, I believe that is true Shane.

Shane: Absolutely Matthew, thanks very much for having me here, I really appreciate that. The opportunity to share a little bit of knowledge about business and really about the adoption of technology in business as well because I am sure we are going to touch on that.

Matthew: Yes, it is a pleasure to have you on Practice DNA so thank you very much.

Shane: My pleasure.

Matthew: Today we are going to talk about business structures and normally I would start off by saying something like I am not a lawyer or an accountant, now you are obviously an accountant but I imagine much of the advice that we are going to discuss today is pretty generic in nature and therefore people should make sure they get their own professional advice.

Shane: Absolutely. So technically it is not actually advice that we will be giving but we will be giving general information and whilst this will help to give your listeners an idea as to various structures that are available on the ins and outs of each structure, you should always seek professional advice. So you certainly shouldn't seek to rely on anything that we discuss here today. It is really just going to provide a good starting point for discussion with the professional advisor.

Matthew: Excellent, good. So there is really three main structures people can sort of look at, isn't it? There is sole trader, partnership or company?

Shane: Yes

Matthew: How do you want to start off, do you want to sort of run through?

Shane: Well, let us just have a quick overview of those structures. So in fact there are four, sole trader, partnership, trust or company and then under trust there are two types of trusts but for simplicity's sake we will just stick with the standard family trust. So first of all the structures, the sole trader structure is probably the easiest to begin with. So this is just an individual that chooses to be in business, no partners and no formal documents necessarily prepared such as company documents and so forth. So it is just an individual trader that decides to get an ABN and operate a business. So common forms of business might be traders such as plumbers, gardeners, builders, all of that sort of thing. In terms of a sole trader, a sole trader is categorized by, first of all a sole trader cannot pay a salary to themselves because you can't employ yourself. All that happens is any profit that the business has made passes straight to the individual. Now that is great on one hand but from a profit perspective it is actually a very simple structure but often with simple structures there is a downside when it comes to liability. So from a liability perspective if you are operating as a sole practitioner whether it will be a chiropractic practice or medical practice, an accountant or as a trader or anything else, the liability tends to be the bigger issue. If you are in a business that is particularly litigious then you don't actually have any protection as a sole trader. This is not to say that you shouldn't consider operating as a sole trader, it just means that you should take appropriate steps to minimize risk and one of those things will be to make sure you have got appropriate insurance.

So what happens is, as a sole trader basically if I conduct an act that causes me to be sued, not only could I be personally liable but any asset that I own is potentially at risk. So even if it is not a business asset, so I know I own my home, it is not just my business assets such as my business motor vehicle or other business tools that are subjected to risk that I will have to sell if I am sued but I could potentially lose what I consider to be my private assets such as maybe my home, some personal shares that I may own, cash in personal bank accounts. So there is no protection at that level.

Matthew: Right, I believe some people get around that by doing things like putting their house in their spouse's name and things like that but that is obviously a fairly drastic step I suppose.

Shane It is a drastic step but in the past that used to be a strategy that we would use, what basically happened with the bankruptcy laws is the bankruptcy laws means that those can be clawed back if it has occurred within a certain period of time prior to the event. So I think if it has been a long standing, and I am not exactly sure on the time in relation to this. So I am not actually a bankruptcy lawyer or a bankruptcy professional but I believe that that they can be clawed back. So you know, if I transfer the house into my wife's name and two years later start a business and the business goes bankrupt for whatever reason, I believe that it can be clawed back but I am just not sure what that time frame is.

I will get back to the structures as well Matthew, I have described the sole practitioner, so one hundred percent of the profits are yours, one hundred percent of the liability is yours. When we look at a partnership, which is sort of the next most complicated structure, beyond that, it is very similar, without complications. So partnership is, you and I might go into partnership, we might have a partner's agreement that says you will receive fifty percent of the profits and I will as well. Again, technically we can't pay salaries to ourselves, we just simply share in the profits fifty fifty and technically we also share in any liability fifty fifty except partnership means that every individual partner is actually jointly and severally liable for any act of the partnership. So that is a probably more technical way to describe it but what it means non-technically is that any decision that you make can bind the partnership and affect me so I might have absolutely no knowledge of a particular transaction. You might go to Ferrari in the centre of town and lease five Ferraris one for each of your family members in the business name, I might have absolutely no knowledge of it, we can't afford the repayment business because of bankrupt, I am jointly and severally liable for your decision in that regard. So there is an added risk involved with the partnership in that one partner has the ability to bind the other party in a decision. So aside from the other risks as well, you know, as a partner if we are sued then my personal assets are at risk, your personal assets are at risk as well as the business and the business assets. I also have another risk in that I can't necessarily control everything you do but I am responsible for everything that you do and vice versa. If I make that decision with the five Ferraris potentially that puts you at risk. So you need again to take appropriate steps, you want appropriate insurance, you want appropriate partnership agreements in place but even if you have got a partnership agreement in place that says that I indemnify you for any wrong decision that I make perhaps, that is an internal agreement, it doesn't necessarily protect you from the party that is wrong. So in that case with the Ferraris, the leasing company will still come after you notwithstanding that you have an agreement with me. Okay, so there is that sort of risk involved in a partnership.

Matthew: So I imagine therefore that for most people that is not much of a structure to go for.

Shane: It is certainly a valid structure and there are plenty of partnerships but it depends on the circumstances. So a partnership, the most common partnerships that we see is a family partnership between husband and wife and that is a perfectly legitimate structure. The other reasons why you might have a partnership notwithstanding these risks are, you know, you might have a very good relationship with the partner and you might need access to capital. So for example I might only have one hundred thousand dollars needed to start a business but by partnering with somebody I might get access to a further hundred thousand dollars, you know, so more funding, more capital, you are sharing the resources and time. And depending on each person's individual circumstances they may weigh up the risks to say well it is well worth us doing notwithstanding that it creates greater risk on the other side and then you obviously take appropriate steps to try and minimise those risks, in other words all decisions, you know, like on your bank accounts, each person must sign, perhaps one person can't sign but still there is risk.

Matthew: Okay, no problem.

Shane: So the next structure that we were talking about was a trust?

Matthew: Yes

Shane: Trust is a more complicated structure. I probably won't go into too much detail other than to say that under a family trust structure, a trust is nothing more than a legal agreement and I might put ten dollars on the table and say this ten dollars is to be managed for the benefit of your family and in doing so I have actually created a trust over that ten dollars and a trust therefore is just a series of rules that are written up to determine how is that ten dollars managed. But in order to manage it you need, well, there are a few things in the trust. First of all we need there to be beneficiaries and the beneficiaries will be your family members

Matthew: Yes

Shane: But we need somebody to manage it. So we need a trustee and the trustee will be either a company or a legal person, so an individual over the age of eighteen or more than one of them perhaps. So the idea is that the trustee is required to manage that ten dollars for the benefit of your family but the trustee has no rights to the asset for its own benefit and likewise, the beneficiaries don't actually own the assets. So it is a bit of an odd situation in that you have got an asset that sits there for the benefit which means that any profits that are made on that pass to the beneficiaries. So if we make a dollar profit, that passes to you and the way family trust works is that the trustee has the discretion to distribute those profits in any way that it sees fit as long as it is to an eligible beneficiary. Now, if it is your family member that are eligible beneficiaries, and to determine what is an eligible beneficiary it is when the trust is created in the first place, it is actually written into the trust deed as to who the eligible beneficiaries are. So the trust deed can make a decision to allocate the profit wherever they want as long as it is to an eligible beneficiary. That means that there are lots of flexibility, so if you are earning a million dollars a year, I probably don't want the to distribute income to you for tax purposes because at the top tax right, but your spouse who maybe isn't working, I might be able to distribute income to her and she might pay zero tax on that profit or a lower rate, well not lower than zero but I mean, a lower rate of say fifteen percent or certainly lower than the maximum rate. So there is flexibility and this is an advantage of a discretionary trust structure. Similarly there is asset protection because by the nature of that a trustee can be indemnified for out of the assets of the trust. So it is like putting a Chinese wall between the business and the manager being the trustee because if the business is sued it really could only loose the assets in the business, the trustee's personal assets may not be at risk. In some cases they can be because the tax office can certainly assess tax against the trustee but what we tend to find is that the general level of protection is actually a lot greater. You have got an extra layer of protection that protects personal assets.

Matthew: Right, which is obviously good when you are engaged in some sort of business that is higher risk.

Shane: Yes, that is right and the other aspect of structuring any of these sorts of things, we have got personal assets that are at risk, if we are staying in business for long enough and if we can actually make it so that personal assets are separated from business assets before the event then there is a greater chance that we are able to protect them.

Matthew: Ok good.

Shane: And the last structure is the company structure and again with the company structure typically if you and your wife owned the company that operated the business, you will be shareholders. Shareholders are the real power in the companies. They are the people that have the right to share in the profit but they also have a voting right. So they have a right to determine who manages or who is the director of the company, who is going to run the company. The directors themselves are the mere employees of the company and they are appointed by the shareholders. So if you are looking at a relationship with the company definitely the shareholding is what you want. In terms of shareholding, how much risk are shareholders up for first of all because we will talk about shareholders first and then we will talk about directors. From a risk perspective the shareholders who are the owners of the business, if you created two dollar company, so you have paid one dollar for each of your shares for a total of two dollars then the most that a shareholder can lose in a company is the unpaid amount of their shares. So if I have bought one share for one dollar but I haven't paid the one dollar and the company goes bankrupt, the most that I can lose is that one dollar that I owe to the company as a shareholder. A director on the other hand has different risks because they are actively managing the business, if they conduct a negligent act, the director could be sued just in the same way that if you are an individual anywhere and you conduct a negligent act you can be sued. Therefore if you are sued in that circumstance, any personal asset that you have is at risk.

Matthew: So you obviously need to be taking advice on what are the correct actions to be taken if you are at all one show.

Shane: That is right. And then when we look at business risks, so I purchased something from a medical supply company but I don't pay the bill for twelve months and then they sue me or they sue the company, the company assets are at risk and not necessarily the director's personal assets. Having said that though, some creditors have the right to claw back assets or to make, you know, the directors can be liable in certain circumstances for certain risks. An example is, if my company doesn't pay your superannuation and the ATO get wind of it, the ATO can recover the superannuation from the director. Likewise they can recover any unpaid taxes from the directors and again a little bit like trader or partnership, if we have got two directors and one director has no money to pay and the other one is incredibly wealthy, they will just claw it back from whomever they can. They will try to make it fifty fifty but they invariably, if they can get it from you and not from me they will go to you every time. So there are risks that are involved and again you can reduce those risks. So first of all you have public liability or professional liability insurance as a first thing, in terms of other directors' insurance, you can apply for directors' liability insurance as well which can then protect you at the director level.

Matthew: Right, so for most people who are starting out, say it is just them working in their business there is obviously certain income levels that you would really need to get to before you start looking at company structures and so on because there is extra levels of cost involved in running that isn't there?

Shane: Absolutely, so a sole trader is a very simple structure, that is probably the cheapest structure to run. Typically what we look at with tax planning is that we look at the level of income but we also do look at this issue of risk in the business and we consult with our clients to say, and really the decision actually comes from the client with guidance from an accountant. The idea being that if you are very very averse to risk then we might put you in a company structure but if you are a little more comfortable with risk and you are just starting out, we might not necessarily go all of the expense of creating a company when operating as a sole trader will do. So in terms of the tax decisions as to whether or not you go for a sole trader or a company or any other structure, what we tend to look at is if you are just starting out in business you are not likely to have as great an income, we would probably look at it to say well, a company tax rate is thirty percent from the very first dollar that is earned. Now we have marginal tax rates in Australia meaning that the first nought to nineteen thousand dollars or thereabouts is tax free, the next sixteen of a thousand dollars is taxed at fifteen percent, the next is taxed at thirty two point five percent basically. So until such time that your profit is going to put you up into a higher tax bracket than the company tax rate.

Matthew: Yes

Shane: You know, if we own X as an issue not considering risk at all, if we are only looking at tax, the only point that you change, so you would go as a sole trader first of all until such time that your taxable income puts you in a tax bracket that is higher than the company tax rate. At that point we might consider putting you in a company or a trust or some other structure because, the idea being that if I can own my first thirty five thousand dollars and pay fifteen cents in the dollar tax that is great, I will be better off doing this as a sole trader than earning that same thirty five thousand dollars and paying thirty percent tax through the company.

Matthew: Yes that makes a lot of sense.

Shane: Then the next step is, ok, once I have earned that thirty five thousand the next dollar that I own in the company is going to be taxed at thirty percent but the next dollar I earn personally is going to be taxed at thirty two point five percent. So the threshold for determining whether I need to be in a different structure just to consider tax purposes might be that threshold. But that is not the only thing to consider and I really need to make this point that there is a lot more rooms around operating the company structure, we can't just, you know, if I am not operating the business, if I am doing contracting for one employer and I decide to set up a company, invariably there is some non-commercial business rules that will kick in that may affect whether or not that is a viable structure for me and it is probably be on the scope of the discussion today but yeah there are other factors. So again in all of these as much as we are giving the listeners an overview of some aspects of the structures, it is really just starting point to have a discussion with an accountant to make sure that they take it again, all of the personal circumstances because as much as we might be limiting it just to the headline tax issues, there are other tax issues that are definitely going to have an effect.

Matthew: Right, lots of different factors that need to be taken into account. So if people wanted to get in contact with you to discuss these matters further how could they do that?

Shane: Ok, so I think you have given our website address which is great and so people can definitely submit inquiries through that and our website address, I will give that again, is www.liveaccountants.com.au, so that is all one word and basically you will have the ability to submit a contact form and ask whatever question you like. We are always happy to return or spend as much time with our potential clients and our existing clients as possible. We don't work on hourly rates so this issue of time is not an issue for us at all. The other thing too is on the website, we have our phone number and you will be able to contact as on that number as well.

Matthew: That will be great, so I will pop those details in the show, so if anybody wants to look those up and yes they can track you down there. Thank you very much for that Shane, we really appreciate you giving up your time and coming in and sharing this valuable information with our listeners and hopefully we can have you on again soon.

Shane: No problem Matthew, thank you very much for inviting me on.

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