

FARM BUSINESS FACT SHEET

FARM BUSINESS STRUCTURES



Business structures explained

PHOTO: ARTHUR MOSTEAD

Ensuring stakeholders are fully informed is critical to establishing a business structure that can be successful now and into the future.

In a perfect, simple farm business world, we would all operate as individual sole traders.

However, factors such as taxes, creditors, expansion, retirement and a desire to leave a generational legacy means most farming families adopt a relatively complex business structure over time.

To ensure that informed decisions are made in advance about what type of business structure best suits the requirements of farming families, consideration should be given to determining:

- the different business structures available;
- the respective disadvantages and advantages of those structures; and

- how the structure will interact with the goals and objectives of the family members.

The types of business structures used by farming families can be divided into three broad categories:

- those comprising individuals only, such as the sole trader;
- those that involve separate legal entities such as companies and trusts; and
- combinations of both.

SOLE TRADER

The sole trader is a person who conducts their business in their own name, without the involvement of a separate legal entity.

Advantages

- Simple to create, easy to control and has minimal Australian Taxation Office reporting requirements, apart from the need to lodge a personal tax return. Income from the farm enterprise is received by the individual and taxed at their personal income tax rate, with the commensurate ability to offset income against other business losses.
- Allows an individual to claim a 50 per cent discount on assessed capital gains from the disposal of an asset that has been held by that individual for at least 12 months.
- Allows a deceased estate to transfer assets to their chosen beneficiaries without triggering a capital gains tax (CGT) event (cost

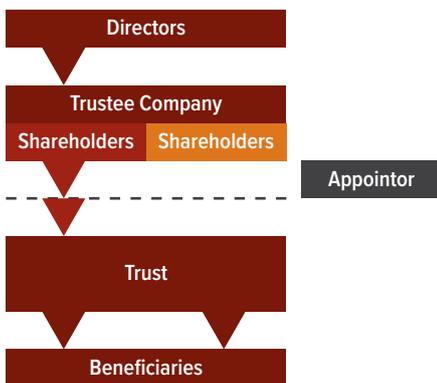
base is inherited with the asset) or stamp duty and as such, offers a significant tax planning opportunity.

- Provided that other criteria are satisfied, allows an individual to transfer farming land during their lifetime stamp duty free.

Disadvantages

- No ability to split farm income between family members.
- Personal assets are at risk should the farming business fail, leaving creditors unpaid.
- Assets left via a will, may be subject to an estate challenge.

Typical discretionary trust structure



DISCRETIONARY TRUSTS

The most common form of trust used by farming enterprises is the discretionary family trust. There are two key roles within this structure; All transactions on behalf of a trust are undertaken by the **Trustee**. This is the person(s) or company that is appointed to conduct the trust’s business with the ‘outside world’. It is the Trustee that usually has the absolute discretion to determine, who of the beneficiaries will receive the income and/or capital of the Trust. Many trusts are drafted to include the additional roles of **Appointor** and/or guardian, and often it is these roles that hold ultimate power in a trust.

For example, while the Trustee may have the power to determine which of the beneficiaries will receive distribution of income, most trust deeds provide that the Trustee is appointed or removed by the person(s) holding the office of Appointor. Consequently, the Trustee operates with the permission of the Appointor.

Advantages

Discretionary trusts have the following advantages:

- The ability to split income between the respective beneficiaries. Most trusts have an extensive list of beneficiaries and can offer significant flexibility in allowing future generations to benefit from distributions.
- Significant asset protection to the beneficiaries, who have no liability for trust debts provided that they have not signed personal guarantees with creditors.
- Depending on the specific circumstances, assets held in a family trust can be quarantined from other liabilities of the farming business and those of individuals involved in the business. The party setting up the trust has the ability to include terms and conditions, which will govern the way in which trust assets are managed in the future.
- Succession of control to the next generation or between family members is relatively simple and can be achieved through the retirement of the Appointor (and guardian if relevant) and the appointment of successors.

Provided that succession is structured outside of a will and documented in the Trust Deed, the transfer of succession cannot be challenged pursuant to estate laws.

Disadvantages

The disadvantages of discretionary family trusts are:

- The Trustee must undertake the transaction of the trust and can be held personally liable for trust debts. While a Trustee can then claim reimbursement from the trust for any losses, if the trust has insufficient assets to fully reimburse the Trustee then the Trustee’s personal assets may be at risk. For asset protection reasons, it is therefore prudent for a Trustee to have no personal assets. As such, the adoption of a Trustee company which holds no assets and does not act in any other capacity is common.
- Care needs to be taken when changing the terms of the original trust deed, as this may trigger what is known as ‘resettlement’ such that CGT and stamp duty may

be levied on trust assets that are subject to CGT and/or stamp duty.

- A family trust has a maximum life of 80 years, or a shorter time period if the Trust Deed has nominated an earlier date (‘Vesting Date’). If this date is overlooked by the Trustee and the Trustee has not made a determination of who will receive the trust assets then these assets will automatically and legally transfer in equal shares to the default persons nominated in the deed.

In most circumstances, it is unlikely that these default persons (often the children of the original Appointor) are those who the Trustee would choose to receive the trust’s assets.

- When trust assets are transferred to a beneficiary, the trust may incur a CGT liability.
- The ability to transfer farmland stamp duty free from a trust to a beneficiary can be restricted by mortgages on farmland. For example, in Western Australia where farmland is vested to a beneficiary and that beneficiary assumes a trust mortgage as part of that transfer, duty is payable on the value of the debt associated with that mortgage.

While not applicable to farming land, other land held in family trusts may be subject to state-based land taxes.

COMPANIES

The adoption of companies as a business structure in farming has significantly reduced from its peak in the 1970s.

Now, companies are primarily used in the role of acting as Trustees of family trusts and they are ideally suited for this role if they hold no assets and play no other role in the farming enterprise.

Disadvantages

The disadvantages of companies and the reason they are not commonly used in farming enterprises to hold assets are:

- Tax losses can be trapped in a company and cannot be used by shareholders to offset income from other sources.
- The cost of setting up and maintaining a company tends to be higher than a family trust as a result of Australian Securities & Investments Commission reporting requirements.
- A company cannot access

BUSINESS NAME VERSUS BUSINESS ENTITY

Registering a business name does not create a separate legal entity. A 'business name' in itself has no inherent legal rights or abilities to do anything that an individual, company or Trustee of a trust would otherwise be able to do. For example, if a lessee wanted to have the lease in the trading name Bill Brown & Sons then the solicitor preparing the lease would conduct a business name search in order to determine the registered holders of that business name.

It is the registered business name holders who will contract in their individual capacity and if a search of Bill Brown & Sons revealed that Bill Brown was the registered proprietor of the name then a lease would record the lessee as being Bill Brown trading as Bill Brown and Sons.

the CGT concessions that are available to individuals (i.e. the 50 per cent discount).

- Directors can be personally liable for company debts in certain circumstances (i.e. for debts incurred while insolvent).
- Directors must familiarise themselves with the Corporations Act and understand their statutory obligations to shareholders and those dealing with the company. Failure to discharge those duties can result in personal liability for losses and ASIC fines.

Advantages

Companies have the following advantages:

- Shareholders will not be liable for the debts of a company.
- Dividends paid to a shareholder are less any tax paid by the company at the company tax rate of 30 per cent (i.e. the shareholder receives a credit for the portion of tax paid by the company).

PARTNERSHIPS

A partnership is an association formed by any number of individuals and/or separate legal entities



PHOTO: EVAN COLLIS

(i.e. trusts) to carry on a business with a view to making a profit.

Partnerships can be informal, with no written partnership agreement such that the partners' conduct and the operation of the partnership are governed by the relevant states partnership legislation ('Acts').

If partners have come together and signed an agreement then the partnership will be governed through an interaction of the agreement and the relevant state legislation.

It is important to note that the provisions of state legislation will override a written partnership agreement unless the legislation expressly provides in respect of a particular obligation, that an agreement can override the legislation.

The law and legislative provisions

The provisions of the common law are not restricted by state boundaries and each state's respective partnership legislation has many common provisions. These include:

- partners have joint and severable liability for all partnership debts, such that each partner is individually liable for the total amount of partnership liabilities.

For example, if a four-member partnership with each partner having 25 per cent equity has \$1.2 million in liabilities then each partner is liable for the entire \$1.2 million, not \$300,000 as represented by their individual equity.

Consequently, creditors can pursue any individual partner for the total debt and this has significant ramifications for an asset-rich partner if the other partners have few assets in their own name (often as a result of adopting asset protection advice and placing off-farm assets in spouses names or in trusts).

This exposure to entire partnership debt can be overlooked when adding children and/or their spouses to the farm partnership. It is essential, that prospective new partners and the existing partners make informed decisions as to the appropriateness of this exposure for all liabilities.

- When partners retire from operational

control of a farming business but remain as partners, their exposure to all partnership liabilities continues. This can have significant consequences on their financial security in retirement.

These implications are best illustrated by an example of an elderly mother who has not been on the farm for 15 years and has no material involvement in the partnership's operations. Should the partnership fall behind on its obligations to creditors then creditors would be entitled to commence proceeding to recover assets from her, including her house.

It is not uncommon to have partners who have never gotten around to taking themselves out of the partnership, as they continue to take minimal drawings for power and telephone expenses. While their involvement may be minimal, their exposure to partnership liabilities is not.

- The acts of a partner in the usual business carried on by the partnership will bind the partnership and the other partners.

The only exception to this provision is where the partner has no authority to act and the person with whom the partner has dealt with knew that the partner had no authority.

This ability to bind other partners without their knowledge can have serious financial consequences. Futures grain trading and machinery acquisitions are common examples of where a farming partnership can find itself with financial obligations that the other partners would not have otherwise consented to.

- A partnership is legally dissolved as at the date of death of a partner and thereafter must be wound up, unless there is a written agreement that expressly provides otherwise.

In the absence of this written

agreement, on the death of a partner the partnership should cease trading and creditors are entitled to freeze all partnership accounts as at the date of death of a partner.

- A partner cannot be expelled by the other partners, unless there is a written agreement that expressly provides otherwise.
- This provision can be problematic where a partner loses legal capacity and their personal legal representative (who is not an existing member of the partnership) takes control of their affairs, or where partners wish to remove a partner because of their actions or inactions.

In the absence of a written agreement, where there is a breakdown in a relationship between the partners, the only solution may be to wind up the partnership and incur the associated costs involved in doing so.

Advantages of a partnership

Some of the concerns relating to partnership structures can be overcome or minimised by the partners taking the time to put in place a well-drafted deed that is tailored to their specific circumstances and requirements. Otherwise, the commonly accepted advantages of this business structure are:

- the legal set up and ongoing administrative costs are not excessive;
- the structure allows income to be split between the partners, whereupon the individual partners pay income tax at their respective personal rates;
- partnership losses can be used to offset a partner's income from other sources; and
- individual partners retain the ability to access the 50 per cent CGT discount and other CGT concessions particular to individuals.

Useful resources

Small Business Development Corporation

www.smallbusiness.wa.gov.au

Department of Industry Innovation and Science

www.business.gov.au

Australian Securities & Investment Commission

<http://asic.gov.au/for-business/your-business/your-business-structure>

Project code

ORM00017

SUMMARY

Farming businesses tend to use several different legal structures, each of which offer different inherent advantages and disadvantages.

Decisions about adopting business structures should only be made after all stakeholders have fully informed themselves how that structure interacts with existing structures and with their own objectives and priorities.

This process is critical, not only for the protection of the current farming generation but to ensure that the next generation inherits a business structure that can promote the ongoing success of the family farming business. □

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