Tax on my mind: Advisors’ recommendations for choice of business form

Brett Freudenberg

The research detailed in this article has two aims. First, to better explore what advisors consider are important factors in the choice of business form; and, secondly, to explore whether tax benefits play a large role in this choice. A better understanding of the underlying motivations in choosing an appropriate business form is needed because making the wrong choice may result in costs for both the business and the broader economy. This article details a study of 81 Queensland advisors, exploring what they thought were important considerations regarding the formation of businesses. The findings suggest that advisors consider asset protection and tax benefits to be most important when recommending business forms.

INTRODUCTION

The legal system can be seen as providing the legal infrastructure to assist and govern the operation of businesses; this includes the nuances of contractual law as well as the creation of different legal business forms. In particular, business forms can create the potential to raise capital and provide a standard set of default rules to provide networking benefits, amongst other things.1

While there are various business forms available, the corporation in particular has been perceived as contributing significantly to the economic development of countries.2 Indeed, the corporation has been described as the “greatest single discovery of modern times”, even exceeding the contribution of steam and electricity.3 This success has been attributed to the corporation’s central characteristics of limited liability, continuity and transferability of membership interests.4 Countries such as Australia see the use of the corporation as inevitably linked to their future economic prosperity, with governments encouraging incorporation through lowering establishment fees and simplification of the regime.5

However, it would be simplistic to think that the only business form is the corporation. The major business forms available in Australia extend from sole proprietors, through general partnerships, limited partnerships, discretionary trusts and unit trusts, to corporations.6 The most frequently used form is that of a sole proprietor.

1 Easterbrook and Fischel have argued that in the absence of transaction costs the supply of clear and simple default rules will be regarded as value enhancing: Easterbrook FH and Fischel DR, The Economic Structure of Corporate Law (Harvard University Press, Cambridge, 1991).
4 Elias, n 3.
5 For example, this is reflected by the decrease of corporation registration fees by 50% to in the federal budget circa 2006, as well as by the corporate law simplification process.
6 There also a number of other forms not listed such as the incorporate limited partnership used for venture capital purposes.
When initially deciding upon which business form to adopt, what are the factors to consider? Some argue that if tax benefits dominate this process it may lead to poor decisions. The Henry Review reiterated this:

Business and investors can use a variety of organisational forms, with considerable variation in the income tax treatment of the entity type and the underlying owners ... This sets up the potential for inefficient outcomes that can affect overall business productivity.7

It is argued that a better understanding of the process of choosing the business form is needed. This is because it has been asserted that if taxes or other regulatory policies interfere with the achievement of the most appropriate business form, real costs could be imposed on the economy.8 Such costs could relate to greater regulatory compliance burden than is necessary given the scale of the business operations.

This article details a study of advisors’ considerations when they recommend a business form, particularly the factors that they think are central to their advice. While the research does not measure the possible inefficiencies of the choice of business form it does highlight that of the 10 factors surveyed, the two most important are asset protection and tax benefits. Also, nearly 70% of advisors acknowledge that the business forms recommended may be too complicated for their clients’ needs.

This article demonstrates that there are different business forms available in Australia with varying tax treatment. It outlines overseas studies which have demonstrated that tax benefits can play a role in the choice of business form, thus posing the question as to what extent do Australian advisors consider tax benefits when recommending business forms. It then outlines the methodology adopted in this study and gives the results before suggesting future research.

**BUSINESS FORMS**

Discussed below are the business forms popularly used in Australia and how their tax treatment varies resulting in different tax imposts on profits.

**Possible business forms**

When commencing a business in Australia there are several possible business forms,9 including sole proprietorships, general partnerships, limited partnerships, discretionary trusts, unit trusts and corporations. Each of these business forms has various regulatory requirements, some unique to particular forms, others overlapping.

A sole proprietor is an individual trading in his or her own name, with the business vehicle having neither a separate legal entity nor perpetual succession. Sole proprietors are seen as having: the ability to control their business activity; low start-up costs; ease of understanding; and limited disclosure requirements. However, they have no limited liability, which means that all of the sole proprietor’s assets, both personal and business, are potentially at risk in the event of business failure.10

For income tax purposes, income derived from business activities conducted by a sole proprietor is included in the individual’s assessable income, and taxed pursuant to the appropriate marginal tax rates, plus Medicare levy. Currently, Australia has progressive marginal tax rates, with the maximum rate for individuals at 45% for taxable income over $180,000.

---

9 It should be noted that some of the business forms listed are not technically a “separate business form”, for example, sole proprietors, general partnerships and limited partnerships. These business forms in Australia did not provide a legal personality separate to their members. However, for consistency the term “business form” is used throughout this article.
10 Of course, the sole proprietor can obtain insurance cover to try to alleviate this exposure, though the cost of this insurance may be prohibitive. Also, the sole proprietor may achieve some limitation of liability (or protection of assets) by placing assets in another entity’s name, such as a spouse, relative, or trustee of a discretionary trust.
Tax on my mind: Advisors' recommendations for choice of business form

Normally, the general partnership will be governed by a partnership agreement and by the state Partnership Acts, which detail such things as management rights, profit sharing, and transferability of membership interests. However, the basic rights and duties outlined in the Partnership Acts are specifically made “subject to any agreement expressed or implied between the partners”. Additionally, under partnership law, the default rules assume that all the partners will be active participants in the management of the enterprise.

A general partnership must have at least two partners, with the maximum number of partners limited to 20 unless the consent of the relevant Minister is obtained. Once the number of partners exceeds 20, the business form must incorporate.

The general partnership does not provide for any limitation of liability for partners, since a partner is jointly and severally liable for the partnership’s liabilities, which means a partner could singularly be responsible for all of a partnership’s liabilities. In relation to partnership torts and breaches of trust, all partners will be liable for any wrongful act or omission of any partner acting in the ordinary course of the business or with the authority of the partners’ co-partners.

Partners’ interests in a general partnership are not freely transferable. Pursuant to the various Australian State Partnerships Acts, no partner may transfer his or her share to render the transferee a partner without the consent of all existing partners. Note that the general partnership (together with sole proprietors) may be required to register the business name, if the business name is not just the names of the partners.

A general partnership is subject to tax flow-through, with partners paying tax in accordance with their individual shares of the net partnership income or loss.

In Australia there are also limited partnerships which are not bodies corporate and which do not have separate legal status for partners. The personal liability of all partners, except for one, may be

---

11 The basic rule provided under the Partnership Acts is that the partners share and contribute equally in the capital and profit of the business: Partnership Act 1892 (NSW), s 24; Partnership Act 1958 (Vic), s 28; Partnership Act 1891 (SA), s 24; Partnership Act 1891 (Qld), s 27; Partnership Act 1895 (WA), s 34; Partnership Act 1891 (Tas), s 34; Partnership Act 1963 (ACT), s 29; Partnership Act 1997 (NT), s 28.

12 Partnership Act 1892 (NSW), s 24; Partnership Act 1958 (Vic), s 28; Partnership Act 1891 (SA), s 24; Partnership Act 1891 (Qld), s 27; Partnership Act 1895 (WA), s 34; Partnership Act 1891 (Tas), s 29; Partnership Act 1963 (ACT), s 29; Partnership Act 1997 (NT), s 29.

13 Corporations Act 2001 (Cth), s 115.

14 However, certain types of general partnerships are allowed to operate with more than 20 partners, including law firms and accountancy firms.

15 Partnership Act 1892 (NSW), s 9; Partnership Act 1958 (Vic), s 13; Partnership Act 1891 (SA), s 9; Partnership Act 1891 (Qld), s 12; Partnership Act 1895 (WA), s 16; Partnership Act 1891 (Tas), s 14; Partnership Act 1963 (ACT), s 13; Partnership Act 1997 (NT), s 13. Note, though, that the partner could sue, under contract, the other partners.

16 Partnership Act 1892 (NSW), s 10(1); Partnership Act 1958 (Vic), s 14(1); Partnership Act 1891 (SA), s 10; Partnership Act 1891 (Qld), s 13; Partnership Act 1895 (WA), s 17; Partnership Act 1891 (Tas), s 15; Partnership Act 1963 (ACT), s 14; Partnership Act 1997 (NT), s 14.

17 Partnership Act 1892 (NSW), s 24(7); Partnership Act 1958 (Vic), s 28(7); Partnership Act 1891 (SA), s 24(g); Partnership Act 1891 (Qld), s 27(g); Partnership Act 1895 (WA), s 34(6); Partnership Act 1891 (Tas), s 29(g); Partnership Act 1963 (ACT), s 29(7); Partnership Act 1997 (NT), s 28(g).

18 Business Names Act 1962 (NSW); Business Names Act 1962 (Vic); Business Names Act 1996 (SA); Business Names Act 1996 (Qld); Business Names Act 1962 (WA); Business Names Act 1962 (Tas); Business Names Act 1963 (ACT); Business Names Act 1963 (NT).

19 Income Tax Assessment Act 1936 (Cth) (ITAA 1936), s 92.

20 Partnership Act 1892 (NSW), s 60; Partnership Act 1958 (Vic), s 60; Partnership Act 1891 (SA), s 58; Partnership (Limited Liability) Act 1988 (Qld), s 10; Limited Partnerships Act 1909 (WA), s 4(2) and Limited Partnerships Act 1905 (Tas), s 4(2).

21 Known as the general partner. To reduce this liability exposure a corporation can be used as the general partner and thus providing limited liability for the member operating through a “corporate” general partner.
limited to the amount of capital contributed by them to the limited partnership.22 However, these limited partners are generally precluded from taking part in the management of the business and have no power to bind the business.23 The limited partnership24 is taxed as a corporation which is described below.25

Corporations limited by shares are the most common form of corporation in Australia, and they provide a separate legal identity and limited liability for members.26 The members are not liable for the debts or obligations of the corporation and the liability of members is limited to the amount (if any) unpaid on shares held by them. Creditors of members are not able to access the corporation’s assets, though member’s creditors may gain control of the member’s share, as an asset itself. However, there are circumstances when a member’s liability will not be limited, and the courts will “lift the corporate veil”.27 Also, the effectiveness of limited liability may be reduced: for example, a member who is also a director of the corporation may in that capacity have breached provisions of the Corporations Act 2001 (Cth);28 or personal guarantees may be required by creditors.

Australia has adopted an imputation system for the taxation of corporations29 and their members. Pursuant to an imputation system, the corporation is still taxed separately on its income, though resident members in receipt of franked dividends from Australian resident corporations can obtain credit for a proportional amount of income tax paid by the corporation.30 Franked dividends are those paid from profits that have borne corporation tax. Currently, the corporate tax rate in Australia is 30%.31

Another possible business form, the trust, can be considered more of a relationship between trustees and beneficiaries rather than as a separate legal form. Trustees are governed essentially by three things: the trust instrument,32 the State and Territory legislation,33 and the trustee’s fiduciary obligations.34 The precise powers detailed in a trust’s instrument will vary significantly from trust to trust, though in modern trust instruments the trustee’s powers are widely drafted.

22 Partnership Act 1892 (NSW), s 60; Partnership Act 1958 (Vic), s 60; Partnership Act 1891 (SA), s 58; Partnership (Limited Liability) Act 1988 (Qld), s 10; Limited Partnerships Act 1909 (WA), s 4(2); Limited Partnerships Act 1908 (Tas), s 4(2).
23 Partnership Act 1892 (NSW), s 67(1); Partnership Act 1958 (Vic), s 67(1); Partnership Act 1891 (SA), s 65(1); Partnership (Limited Liability) Act 1988 (Qld), s 16(1); Limited Partnerships Act 1909 (WA), s 6(1); Limited Partnerships Act 1908 (Tas), s 6(1). If the limited partner does participate in management, then the limited partner will be liable as the same as the general partner(s) for all firm liabilities incurred while management participation occurred: Partnership Act 1892 (NSW), s 67(2); Partnership Act 1958 (Vic), s 67(2); Partnership Act 1891 (SA), s 65(2); Partnership (Limited Liability) Act 1988 (Qld), s 16(2); Limited Partnerships Act 1909 (WA), s 6(1); Limited Partnerships Act 1908 (Tas), s 6(3).
24 A limited partnership is defined for tax purposes as either: (a) an association of persons (other than a company) carrying on business as partners or in receipt of ordinary income or statutory income jointly, where the liability of at least one of these persons is limited; or (b) an association of persons with a separate legal personality that was formed solely for the purpose of becoming a venture capital limited partnership, an Australian venture capital fund of funds (AFOF) or a venture capital management partnership and to carry on activities that are carried on by a body of that kind: Income Tax Assessment Act 1997 (Cth) (ITAA 1997), s 995-1.
25 The flow-through treatment of limited partnerships was eliminated by the introduction of ITAA 1936, Div 5A with limited partnerships being defined as “corporate limited partnerships”.
26 A corporation limited by shares is defined as “a corporation formed on the principle of having the liability of its members limited to the amount (if any) unpaid on the shares respectively held by them”: Corporations Act 2001 (Cth), s 9.
27 For example, Giford Motor Co Ltd v Horne [1933] Ch 935.
28 For example, Corporations Act 2001 (Cth), s 180: exercise reasonable care and diligence.
29 This includes corporate limited partnership (except for the tightly regulated venture capital incorporated limited partnerships: ITAA 1936, s 94D(2)) and public unit trusts.
30 ITAA 1997, s 207-20.
31 Individual members in receipt of franked dividends include in their assessable income the amount of the cash dividend received and the imputed amount of the corporation’s profits (often referred to as the “gross-up” amount of the dividend). A credit is then given to the taxpayer (a “franking credit” or “franking rebate”): equal to the imputed amount that is then decreased from the individual’s primary tax liability. If there are excess franking credits, then from 1 July 2000 certain members are eligible to a refund of this excess amount.
32 Also known as the “trust deed”.
Types of trusts can be distinguished in several ways, including when and how they were established.\(^35\) or how the beneficiaries’ entitlements are to be determined – such as a discretionary or fixed trust. A discretionary trust exists when, pursuant to the trust deed, the trustee has the absolute discretion as to which beneficiaries (mere objects) will enjoy the income or the capital of the trust estate.\(^36\) An example of a fixed trust is a unit trust,\(^37\) which has a similar regulatory and tax treatment to that of a discretionary trust. The key difference is that with a unit trust the beneficiary’s interest is normally fixed and represented by the holding of units in the unit trust.\(^38\)

A trust can provide some limitation of liability for its members. Generally, trustees are personally liable for debts incurred on behalf of the trust, although generally the trustee will have a right to be indemnified (or reimbursed) out of trust assets for the claim.\(^39\) The beneficiaries are generally not liable for the debts incurred by the trustee, unless they have given specific directions to the trustee and the debt arises because the trustee has acted in accordance with those directions.\(^40\)

In Australia all trusts established have to vest\(^41\) within a certain period. This is known as the rule against perpetuity, which means that most trusts do not provide members a business form with perpetuity. Owing to the nature of the discretionary beneficiaries, it is not possible for them to transfer their “interest” until an interest is created, whereas unit holders in a unit trust can.\(^42\)

Trusts are subject to a partial tax flow-through: income can be assessed directly to members (beneficiaries) but losses are confined within the trusts themselves. Tax preferences do not

\(^{35}\) Note each State and Territory in Australia has its own Trust Act. These are the Trusts Act 1973 (Qld); Trustee Act 1958 (Vic); Trustee Act 1925 (NSW); Trustee Act 1936 (SA); Trustee Act 1898 (Tas); Trustee Act 1962 (WA); Trustee Act 1925 (ACT); Trustee Act 1893 (NT).

\(^{36}\) If the trust instrument is silent in relation to a power, then the trustee legislation can confer additional powers and obligations on the trustee; unless a contrary intention is expressed in the trust instrument: Trusts Act 1973 (Qld), s 4; Trustee Act 1958 (Vic), s 2(3); Trustee Act 1925 (NSW), ss 14A – 14D; Trustee Act 1898 (Tas), s 5(1); Trustee Act 1962 (WA), s 5(2); Trustee Act 1925 (ACT), s 14; and Trustee Act 1893 (NT), s 5. Though in some circumstances the trustee legislation can override the trust instrument (see Trusts Act 1973 (Qld), s 21(1)(e)). Constraining this general power are the obligations and duties to which the trustee must comply with. These obligations include adhering to the trust instrument, to act equitably, honestly and impartially (particularly as between beneficiaries and classes of beneficiaries), and to exercise reasonable care: Betts RW, Buchanan RH and Bast R, Corporate Trustees: Disclosure, Taxation and the Liability of Officers (CCH Australia, 1979) p 41. Generally, the trustee holds the legal title in the trust assets.

\(^{37}\) For example a trust established by a person while the person is alive is known as an “inter vivos trust”, whereas a trust established through a deceased person’s will is known as a “testamentary trust”. Also, sometimes a trust can be said to arise for equitable purposes – such as a constructive trust.

\(^{38}\) It has been observed that there is no fixed meaning of a “discretionary trust”, as it is disclosed by a consideration of usage rather than doctrine: Chief Commissioner of Stamp Duties (NSW) v Buckle (1998) 192 CLR 226; 37 ATR 393.

\(^{39}\) A unit trust is a common example of a fixed trust. A fixed trust means that the members’ entitlement to income or capital of the trust are fixed. For the purposes of this article, the term “unit trust” will be used, though the principles discussed normally would have general application to fixed trusts.

\(^{40}\) An example of a fixed trust is a unit trust, the unit holders are entitled to share in the trust net income in proportion to their holding of units in the trust. The unit trust deed usually contains provisions for the trustee to make a distribution of net income by a stated distribution date.

\(^{41}\) It has been observed that there is no fixed meaning of a “discretionary trust”, as it is disclosed by a consideration of usage rather than doctrine: Chief Commissioner of Stamp Duties (NSW) v Buckle (1998) 192 CLR 226; 37 ATR 393. For a thorough discussion of the nature of discretionary beneficiaries’ interest, see Freundenberg B and McDermott P, “The Forgotten CGT Events: Are Asset Revaluations Reserve Distributions by Trustees of Discretionary Trusts Taxable?” (2005) 34 AT Rev 67. However, unlike members of a discretionary trust, unit holder members are able to transfer their interests, though the trust deed may contain restrictions on this transfer.

\(^{42}\) This is because cases have held that a discretionary beneficiary has no beneficial interest in either the income or capital of the trust until an appropriate resolution by a trustee or an act of default has occurred. At best the discretionary beneficiary can call upon the trustee to decide whether to exercise its discretion or, if the discretion has been exercised, to complain to the court on behalf of the trust that it has been exercised in bad faith for purposes outside the purpose of the trust. See Gartside v Inland Revenue Commissioners (1968) AC 553; [1968] 1 All ER 121; Chief Commissioner of Stamp Duties (NSW) v Buckle (1998) 192 CLR 226; 37 ATR 393. For a thorough discussion of the nature of discretionary beneficiaries’ interest, see Freundenberg B and McDermott P, “The Forgotten CGT Events: Are Asset Revaluations Reserve Distributions by Trustees of Discretionary Trusts Taxable?” (2005) 34 AT Rev 67. However, unlike members of a discretionary trust, unit holder members are able to transfer their interests, though the trust deed may contain restrictions on this transfer.
always flow through to beneficiaries, although a conduit principle may apply to distributions, provided sufficient records are maintained. Such a conduit principle means that trust receipts retain their character in the hands of the beneficiary, thereby enabling beneficiaries to take advantage of concessional treatment applying to different receipts. Beneficiaries who are presently entitled to the income of the trust can be taxed on their respective share of the trust’s net income.

Consequently, it can be appreciated that the choice of business form can have an effect on how, who and at what rate business profits are taxed in Australia.

Utilisation of business forms

To appreciate to what extent the different business forms are used data is provided about their current utilisation. When considering income tax returns data, of the 2,906,073 taxpayers in 2010 who indicated that they were conducting a business, 36% were sole proprietors, 27% corporations, 24% trusts and 13% partnerships: see Table 1.

**TABLE 1 Australia: Lodgement of tax returns – business**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole proprietor</td>
<td>958,489</td>
<td>1,058,302</td>
<td>1,005,567</td>
<td>1,044,386</td>
</tr>
<tr>
<td>Partnerships</td>
<td>419,246</td>
<td>419,315</td>
<td>393,115</td>
<td>382,400</td>
</tr>
<tr>
<td>Trusts</td>
<td>609,915</td>
<td>660,324</td>
<td>659,744</td>
<td>702,080</td>
</tr>
<tr>
<td>Corporations*</td>
<td>750,227</td>
<td>772,435</td>
<td>762,442</td>
<td>777,207*</td>
</tr>
<tr>
<td>Total</td>
<td>2,737,877</td>
<td>2,910,376</td>
<td>2,820,868</td>
<td>2,906,073</td>
</tr>
</tbody>
</table>


*Limited partnerships are not recorded separately and are included in the corporation figure. In 2010 there were 386 limited partnerships with taxable income greater than $0 (see ATO, Table 3.10, p 26.)

In terms of size, 99.9% of sole proprietors have less than $2 million in turnover. Excluding those taxpayers who have “nil business income”, of the businesses with less than $10 million income (categorised by the ATO as “small”), 45% are sole proprietors, 28% corporations, 14% partnerships and 13% trusts. According to the Australian Business Register, there are currently 2,684 limited partnerships registered for a business number. For taxpayers with business income greater than $10 million, the corporation is the most popular (73%), followed by trusts (19%), partnerships (5%) and sole proprietors (2%): see Table 2.

43 *Bamford v FCT* (2010) 240 CLR 481; 75 ATR 1; see also Sch 2 of the *Tax Laws Amendment (2011 Measures No 5) Act 2011* (Cth).

44 For example, a capital gain realised by a trustee will be treated as a capital gain in the hands of a beneficiary presently entitled to it. For a discussion about the conduit theories application to discretionary trusts see: Freudenberg and McDermott, n 42.

45 In some circumstances the flow-through of tax preferences will be tax free receipts for beneficiaries; for example when accounting income exceeds taxable income – see Freudenberg B, “Are Asset Revaluation Reserve Distributions ‘Ordinary Income’ for Discretionary Beneficiaries?” (2005) 20(1) *Australian Tax Forum* 3. In comparison, for a beneficiary of a fixed (unit) trust the receipt of a tax preference could result in the decrease of the cost base of their membership interest: *ITAA 1997*, s 104-70.

46 *ITAA 1936*, s 97. In the circumstance where the beneficiary, although presently entitled, is under a legal disability, the trustee is taxable on the share of trust net income in a representative capacity. The trustee is also assessable in cases where the beneficiary is a non-resident. All net income of the trust to which no beneficiary is presently entitled initially falls within the ambit of s 99A, with the trustee liable for tax. In a limited number of cases, the Commissioner has discretion to assess the trustee under s 99.

TABLE 2 Australia: Lodgement of tax returns – size

<table>
<thead>
<tr>
<th>Business form</th>
<th>Loss &lt; $0</th>
<th>Nil = $0 (ie not in business)</th>
<th>Micro &gt; $0 but &lt; $2M</th>
<th>Small &gt;$2M but &lt;$10M</th>
<th>Medium &gt;$10M but &lt;$100M</th>
<th>Large &gt;$100M but &lt;$250M</th>
<th>Very Large &gt;$250M</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole proprietor</td>
<td>1,352</td>
<td>11,335,642</td>
<td>1,038,850</td>
<td>3,734</td>
<td>445</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Partnerships</td>
<td>301</td>
<td>69,481</td>
<td>304,414</td>
<td>7,139</td>
<td>979</td>
<td>54</td>
<td>30</td>
</tr>
<tr>
<td>Trusts</td>
<td>727</td>
<td>405,871</td>
<td>271,285</td>
<td>20,281</td>
<td>3,754</td>
<td>122</td>
<td>38</td>
</tr>
<tr>
<td>Corporations</td>
<td>1,817</td>
<td>110,598</td>
<td>600,431</td>
<td>49,419</td>
<td>12,916</td>
<td>1,099</td>
<td>927</td>
</tr>
<tr>
<td>Total</td>
<td>4,197</td>
<td>11,921,592</td>
<td>2,214,980</td>
<td>80,573</td>
<td>18,094</td>
<td>1,277</td>
<td>988</td>
</tr>
</tbody>
</table>

Source: ATO, Taxation Statistics: A Summary of Tax Returns for the 2006 to 2010 Income Years (2012), Table 1.3. Data processed up to 31 October 2011.

While each business form has been discussed separately here, it is simplistic to consider the business forms in isolation because in practice often a combination of business forms (concurrent use) is used in the one business venture to achieve desired features related to tax and non-tax attributes, such as improved asset protection and the sharing of losses. The Australian government recognises this concurrent use of business forms and has allowed, for example, general partnerships and trusts to be part of a consolidated group of corporations, and has also allowed the small business capital gains tax (CGT) concessions to apply to the renting of assets between related entities.

Given the wide variety of utilisation of business forms, the next section will discuss whether there is evidence to explain the motivations behind the choice of business form.

CONCERNS ABOUT THE BUSINESS FORM

The issues affecting the selection of business forms are numerous and complex. One is the consideration of the regulatory burdens including governing statutes, industry practice and the ability to raise finance. Another is the potential tax implications, which could extend to considering the tax rate, use of losses, complexity, state taxes and eventual sale of the business. Khandekar and Young suggested that, when advising a client on business form selection, an advisor must consider the advantages and disadvantages of the tax issues and the non-tax issues of each structure available. In evaluating these, a clear understanding of the client’s objectives is critical because these should be the essential driver. For small business owners the dominant objectives may relate to control and management of the business, liability protection, and the minimisation of both professional fees and tax liability.

Two particular concerns have been raised about selecting the business form: the general suitability of the business form and the undue influence of tax benefits. Both are explored below.

48 An example of this is where a trustee of a discretionary trust may conduct business operations (such as a restaurant operation), with the actual business assets held by a corporation that leases the assets to the trustee of the discretionary trust (such as the land and buildings in which the restaurant business is conducted). This concurrent use of business forms ensures that the relevant assets are protected from claims made by creditors or tortfeasors against the operating entity.

49 For example, there may be a general partnership of two or more discretionary trusts operating a business. Such a combination would allow for the profits or losses of the general partnership’s business to flow-through to the discretionary trusts. This combination would also provide some liability protection for members using discretionary trusts with corporate trustees.


51 ITAA 1997, s 154-40.


Suitability

Concerns have been raised about the suitability of different business forms, particularly relating to the size of business and the regulatory burden or ownership structure. For example, Freedman and Godwin have raised concerns about the different forms being used by small businesses, as they consider that there is “a mismatch between the economic and legal analysis and objectives of the legal forms and the use made of these forms”. Their reasoning is that the choice of business forms is not governed by factors such as size, assets or management structure. They highlight:

A company may be, and frequently is, a one-person concern with only nominal capital; unincorporated firms may be substantial with large borrowings.

If there is improved choice of business form from the beginning, it has been argued that this will “reduce costs, both financial and in terms of management time, particularly at start-up when the strain on both is at its greatest”.

However, it is questionable to what extent complete advice is obtained at the time of formation of the business. Research has demonstrated that small, closely held businesses may not adopt tailored governance rules owing to the limited availability of financial resources, the uncertainty about future operations, the paucity of understanding about business forms, and the use of accountants for business formation.

For example, in a United Kingdom study in the early 1990s, Hicks et al sought to investigate why small businesses chose to incorporate, what the role of advisors was in this decision, and what the consequences were of such decisions. The role of accountants in assisting with incorporation was found to be great: 70% of corporations were formed by accountants, 13% by company registration agents, and only 12% by solicitors. How well considered these incorporation processes were is questionable, since formal advice was only sought in 36% of cases, and 97% of that advice was from accountants, with the remaining 3% from solicitors.

With those United Kingdom businesses using the general partnership form, only 43% had a formal partnership agreement. Unlike corporations, solicitors played a larger role in general partnerships, with 85% of these being drawn up by a solicitor, and 15% by an accountant. The difference between corporations and general partnerships may have to do with reforms that make
setting up a corporation relatively easy, so that no legal qualification is required to purchase the corporate shell “off the shelf”. For sole proprietors, when formal advice was obtained, 50% was from accountants and 30% from solicitors.66

Hicks et al concluded that the reason accountants were so heavily involved in the decision to incorporate (as well as the other business forms considered) could be owing to “the close involvement of accountants with small business, and their detailed knowledge of the financial and tax affairs of their clients”.67 It is suggested that Australia could be similar, with the accountant being dominant in the role of giving business form advice, particularly when businesses are starting off. This inference is supported by the findings of the Australian study into entrepreneurship, as chartered accountants were found to be the most important type of paid consultant in the start-up phase.68

In terms of receiving formal advice in the United Kingdom there was a strong similarity between corporations, general partnerships and sole proprietors, as in approximately one-third of circumstances formal advice was obtained.69 That means in two-thirds of circumstances no formal advice was obtained when setting up a business. It is argued that this is of concern, given the complexities around the issue and the long-term implications.

The study by Freedman and Godwin70 supported these findings; they found a lack of “tailoring” of the corporate form to any individual needs; only 8% reported that articles (constitution) were tailored to their own requirements.71 They found 25% indicated standard form documentation with a few changes; 75% believed they had an “off-the-shelf” standard form.72

The findings overseas appear to have resonance in Australia. An Organisation of Economic Co-operation and Development (OECD) study of Australian businesses found that 59%-69% of businesses had trouble understanding regulations.73 It appears that small business owners often have a poor understanding of regulatory requirements, with 62%-75% of businesses stating it is not possible to comply with all the regulations they should.74 For example, even with the improvements owing to the Corporations Act simplification program, there are still criticisms that a corporation’s internal governance rules are too onerous for closely held businesses to deal with.75 But it should be noted that the corporation continues to be frequently used.

Consequently, it appears that accountants can have an important role with business formation advice, although their advice may not be comprehensive owing to a number of factors.

Breaches of tax neutrality

Concerns have also been raised about when tax benefits play a dominant role in the choice of business form. Freedman and Godwin have argued that the choice of business form needs to be based on

66 Hicks et al, n 58, p 23
67 Hicks et al, n 58, p 28.
69 For corporations it was 36% of cases; for general partnerships, 36.6%; and for sole proprietors, 31%.
70 Freedman and Godwin conducted a survey in the early 1990s in the United Kingdom. They surveyed 429 firms, conducted 24 face-to-face interviews with small businesses, and 12 with auditors. While they did not use a measure for “small”, they instead used the qualitative measure of “closely held”, in that was management and ownership in the same hands. Freedman and Godwin, n 57, p 108.
72 Freedman, n 71, p 27.
74 OECD, n 73.
commercial considerations, rather than having tax dominate. These arguments are based on the notion of tax neutrality. That is, regardless of the business form adopted, the tax burden should be equivalent. A tax system would be “neutral” in terms of business form selection if it did not affect the choice of business form, the decisions on investments, or the sources of finance. However, as already canvassed, the tax treatment of business forms in Australia varies greatly and is not neutral.

Theoretically on the basis of tax neutrality, this “tax wedge” should be the same irrespective of the business form adopted. Theoretically, this “tax wedge” should be the same, irrespective of the business form adopted, on the basis of tax neutrality. The selection of business form can determine, in this respect, precisely how ownership risks and returns are shared and how management is controlled. Individuals can be expected to adopt business forms, financial policies and investment options that maximise returns or, conversely, minimise costs (including, for example, the costs of monitoring managers’ performance). According to Scholes and Wolfson, this choice involves a trade-off between tax costs and non-tax (transaction) costs, with firms more likely to choose a business form that will minimise these costs overall.

The question needs to be raised as to whether there is any evidence to support the contention that taxpayers would be influenced in their choice of business form owing to its tax treatment. In this way the choice of business form can be part of a taxpayer’s strategy to obtain tax benefits in respect of the income generated by the business. Other well-recognised tax strategies include deductible payments to related entities, the classification of receipts as capital in nature rather than revenue, the bringing forward of deductions, income sheltering and income splitting. In Australia, several cases have held that Part IVA (or its predecessor) applied to the creation of a business form, as a taxpayer’s primary or dominant motivation was to achieve a tax benefit.

Several studies have also illustrated that there is a potential for this to occur. These studies have observed or predicted changes in the utilisation of certain business forms, given changes in the tax system. In the United States, Scholes and Wolfson, Ayers et al, and Gordon and MacKie-Mason considered the effect on business form choice owing to the United States’ Tax Reform Act 1986 (US) (referred to as the 1986 tax reforms). In Australia, Holub analysed the utilisation of public unit trusts, given changes to their tax treatment. While not conclusive, these studies tend to support the argument that taxpayers’ choice of business form can be influenced by tax benefits.

For example, Gordon and MacKie-Mason observed a massive surge in S Corporation elections following the 1986 tax reforms because the S Corporation could provide the benefits of corporate

76 Freedman and Godwin, n 55, p 107.
79 Harris, n 2, p 107.
80 Bevin, n 8, p 7.
82 For example, FCT v Gulland; Watson v FCT; Pincus v FCT (1985) 160 CLR 55; 17 ATR 1; Tupicoff v FCT (1984) 4 FCR 505; 15 ATR 1262; Case 2/2004 AATA 349.
83 Freedman and Godwin, n 55, p 10.
84 S 47 A 2008; 18 ATR 1; 19 ATR 2; TUPICOFF v FCT (1984) 4 FCR 505; 15 ATR 1262; Case 2/2004 AATA 349.
characteristics and also provided flow-through taxation which could achieve an overall lower tax rate compared to the C Corporation which was subjected to a classical tax system.\(^8^7\)

An empirical study by Ayers et al considered both tax and non-tax factors by studying a sample of small businesses in the United States.\(^8^8\) Their results suggested that non-tax factors such as business risk, ownership structure, firm size and age are all important in the selection of a business form. However, they found only partial support for the hypothesis that taxes were an important consideration. Their evidence suggested that members used S Corporations rather than C Corporations for businesses that realise losses in the early years of their operation, which is entirely understandable given the flow-through of losses with S Corporations.

In the United Kingdom, while tax considerations were a factor, Hicks et al found that limited liability was the dominant reason to incorporate – both from the advisors’ point of view and that of those who did not obtain advice (see Table 3). However, for advisors, tax was the second most important factor,\(^8^9\) whereas for those without advice, “prestige” was the second most important. Consequently, it appears that advisors give greater weight to tax considerations when providing advice about whether to incorporate or not – although it is not the dominant factor.

**TABLE 3 United Kingdom: Reasons for incorporating**

<table>
<thead>
<tr>
<th>Reason</th>
<th>Reasons given by advisors to clients</th>
<th>Directors reasons (when no advice obtained)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limited liability</td>
<td>56%</td>
<td>61%</td>
</tr>
<tr>
<td>Prestige/liability</td>
<td>3%</td>
<td>20%</td>
</tr>
<tr>
<td>Tax reasons</td>
<td>22%</td>
<td>9%</td>
</tr>
<tr>
<td>Defines membership interest</td>
<td>0</td>
<td>14%</td>
</tr>
<tr>
<td>Easier to transfer interest</td>
<td>0</td>
<td>5%</td>
</tr>
<tr>
<td>Facilitate raising of capital from outside investors</td>
<td>0</td>
<td>4%</td>
</tr>
<tr>
<td>Protect business name</td>
<td>0</td>
<td>2%</td>
</tr>
<tr>
<td>To offer floating security to bank</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Corporation form necessary for trading purposes</td>
<td>0</td>
<td>5%</td>
</tr>
<tr>
<td>To reflect size of business</td>
<td>0</td>
<td>4%</td>
</tr>
<tr>
<td>To run business through separate legal entity</td>
<td>0</td>
<td>5%</td>
</tr>
<tr>
<td>To continue original status after purchase</td>
<td>0</td>
<td>5%</td>
</tr>
<tr>
<td>Discipline of running business through company beneficial</td>
<td>6%</td>
<td>0</td>
</tr>
<tr>
<td>No considered reason</td>
<td>0</td>
<td>4%</td>
</tr>
<tr>
<td>Other</td>
<td>6%</td>
<td>6%</td>
</tr>
<tr>
<td>Number of respondents</td>
<td>32</td>
<td>56</td>
</tr>
</tbody>
</table>


Freedman and Goodwin also found, for United Kingdom businesses, that tax was not the dominant reason and for unincorporated business forms (that is, sole proprietors and general partnerships), that personal control was a major reason for the choice of business form (87% for sole proprietors; 67% for partnerships) (see Table 4). The low formality of the business (such as simple accounting requirements, few formal meetings, easy to start up and owning property in own name) was a larger contributing factor (greater than 50% for sole proprietors).\(^9^0\) However, tax did play a part, since 39% indicated that tax was an important reason in their choice.\(^9^1\)

---

\(^8^7\) Gordon and MacKie-Mason, n 85, p 118. Although they recognised that the number of business forms is not indicative of economic activity, with a majority of assets remaining with C Corporations.

\(^8^8\) Ayers et al, n 84 at 50.

\(^8^9\) This is supported by interviews done with advisors themselves with two-thirds indicating the reason to recommend incorporation related to limited liability and one-third to tax reasons.

\(^9^0\) Freedman and Godwin, n 55, p 109.
TABLE 4 United Kingdom: Reasons for setting up unincorporated business

<table>
<thead>
<tr>
<th>Ranking</th>
<th>Reason</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Personal control</td>
</tr>
<tr>
<td>2</td>
<td>Simple accounting requirements</td>
</tr>
<tr>
<td>3</td>
<td>Few formal meetings</td>
</tr>
<tr>
<td>4</td>
<td>Easy to start</td>
</tr>
<tr>
<td>5</td>
<td>Property owned in own name</td>
</tr>
<tr>
<td>6</td>
<td>Control over selecting partners</td>
</tr>
<tr>
<td>7</td>
<td>Confidential financial records</td>
</tr>
<tr>
<td>8</td>
<td>Easy to retrieve capital</td>
</tr>
<tr>
<td>9</td>
<td>Tax reasons</td>
</tr>
<tr>
<td>10</td>
<td>No need to find second shareholder</td>
</tr>
<tr>
<td>11</td>
<td>Prestige/creditability</td>
</tr>
<tr>
<td>12</td>
<td>Raising finance</td>
</tr>
</tbody>
</table>


For those businesses that chose a corporation, the reason given greatest importance was limited liability to third parties, but also 50% thought that prestige/creditability was part of their reasoning (see Table 5). The third most important reason (38%) related to the tax implications of their choice.

TABLE 5 United Kingdom: Reasons for setting up incorporated business (corporation)

<table>
<thead>
<tr>
<th>Ranking</th>
<th>Reason</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Limited liability to third parties</td>
</tr>
<tr>
<td>2</td>
<td>Prestige/creditability (50%)</td>
</tr>
<tr>
<td>3</td>
<td>Tax reasons (38%)</td>
</tr>
<tr>
<td>4</td>
<td>Accounting reasons</td>
</tr>
<tr>
<td>5</td>
<td>Administrative reasons</td>
</tr>
<tr>
<td>6</td>
<td>Owning property in firms name</td>
</tr>
<tr>
<td>7</td>
<td>Pension advantages available</td>
</tr>
<tr>
<td>8</td>
<td>Finance (23.8%)</td>
</tr>
<tr>
<td>9</td>
<td>Ease of transferring share (17.4%)</td>
</tr>
<tr>
<td>10</td>
<td>Limited liability to shareholder</td>
</tr>
</tbody>
</table>


Reflecting upon the Australian experience, Holub studied the use of public unit trusts in Australia during the 1980s, following the theory espoused by Scholes and Wolfson. In the 1980s, public unit trusts were initially subject to partial tax flow-through and then with amendments taxed as corporations with an imputation system applying. Holub considered that, given that both forms were now subject to the same tax treatment, the preferred business form between the public unit trust and corporation would be the one that had the greater non-tax advantages. He found that seven of the eight public unit trusts studied chose to re-organise/re-constitute to a corporation after the

93 Holub, n 86, p 328.
amendments.\textsuperscript{94} It would appear from Holub’s findings that the initial choice to use the public unit trust prior to the tax changes must have been largely based on tax considerations, and not on their non-tax advantages.\textsuperscript{95}

Based on the analysis above, it is argued that breaches of tax neutrality in terms of business forms can distort taxpayers’ decisions about which business forms to utilise, although the study by Ayers et al found only partial support for this. Therefore, there appears to be some empirical evidence that tax can distort the choice of business form; however, it is not always found to be the dominant reason for the choice. It is not argued that businesses should ignore the potential tax implications of their business form choice; instead, concern is raised when tax is the dominant reason because it is questionable whether the most appropriate commercial decision has been made.

The negative impact of choosing a business form owing to possible tax benefits was highlighted by Hicks et al. In their study, for the 22\% of corporation owners who considered that the disadvantages of incorporating outweighed the advantages, tax was more likely to have played a larger role in their initial decision to incorporate.\textsuperscript{96} This may indicate that making tax the dominant consideration for the choice of business form may lead to dissatisfaction. Based on the literature concerning the overseas’ experience and the paucity of research in Australia in this area, research was undertaken to gain a greater understanding of the factors considered when choosing a business form.

**Survey about the Business Form**

The research detailed in this article had two aims: first, to better explore what advisors consider are the important factors in the choice of business form; and, secondly, to explore whether tax benefits play a large role in this choice.

To address these research aims, a quantitative survey was implemented. The wording of the survey instrument was developed from pilot groups and feedback obtained. The final survey instrument consisted of three parts, two of which are relevant for this article. The first part requested brief demographic details. Another section then sought opinions about the factors on choice of business form and the relationship to tax benefits. The author collated this list of factors from prior research (such as Freedman and Godwin,\textsuperscript{97} and Hicks et al\textsuperscript{98}) and from the literature in the area (such as Porcaro).\textsuperscript{99} The list was initially pilot tested and refined. The final list of factors consisted of the following: asset protection,\textsuperscript{100} business expansion,\textsuperscript{101} CGT concessions,\textsuperscript{102} tax compliance cost,\textsuperscript{103} equity raising,\textsuperscript{104} level of risk,\textsuperscript{105} limited liability,\textsuperscript{106} prestige,\textsuperscript{107} succession planning,\textsuperscript{108} and tax benefits/savings.\textsuperscript{109}

\textsuperscript{94} Holub observed that high reorganisation costs were instrumental for the one non-converting trust, although it did make changes to its trust deed to provide greater flexibility in raising equity capital, similar to a corporation.

\textsuperscript{95} Holub, 86, p 330.

\textsuperscript{96} Hicks et al, n 58.

\textsuperscript{97} Freedman and Godwin, n 55.

\textsuperscript{98} Hicks et al, n 58.

\textsuperscript{99} Porcaro, n 52.

\textsuperscript{100} “Asset protection” is referring to the notion of protecting either the business assets or the assets of the member from liability exposure due to the business operations or other members’ activities. The protection can be from creditors or tortfeasors.

\textsuperscript{101} “Business expansion” is referring to the notion that the business form allows for the business operations to grow. This can include that the business form is recognised internationally, it is readily accepted by banks to facilitate borrowing and/or allows for the introduction of other equity members.

\textsuperscript{102} “CGT Concessions” refers to the concessional treatment provided to capital gains pursuant to the ITAA 1997, including the 50% discount for CGT assets held greater than 12 months and the small business CGT concessions.

\textsuperscript{103} “Tax compliance cost” is referring to the the costs that taxpayers face as a result of complying with their taxation obligations, which can include internal and external costs.

\textsuperscript{104} “Equity raising” refers to the concept that the business form provides the ability to attract additional equity members.

\textsuperscript{105} “Level of risk” is referring to the notion that some business operations or activities may involve a greater level of risk.
To facilitate data collection, a survey was conducted of 81 advisors in Queensland attending six continuing professional development (CPD) seminars conducted by the Taxation Institute. Approximately 240 advisors were in attendance at these seminars. The Taxation Institute is a professional body representing tax practitioners; the CPD seminars were an assembly of its members and prospective members. This formed the exact pool of potential respondents required to perform the survey. Owing to the sample size and the jurisdictional restraints, the findings of this study may not be representative; however, they may demonstrate interesting trends.

Descriptive statistics

Table 6 presents summary demographic statistics of the survey participants. Broadly, there was a balance in terms of gender, age, position and number of years of experience. With regard to the highest completed level of education, the cluster in the CPA/CA bracket was expected as the majority of degree-qualified accountants continue their professional development, gaining either CPA or CA status for career advancement purposes.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Factors</th>
<th>Values</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>N</td>
<td>81</td>
</tr>
<tr>
<td>Gender</td>
<td>Male</td>
<td>55%</td>
</tr>
<tr>
<td></td>
<td>Female</td>
<td>45%</td>
</tr>
<tr>
<td>Age</td>
<td>25 or Less</td>
<td>19.8%</td>
</tr>
<tr>
<td></td>
<td>26-35</td>
<td>37.0%</td>
</tr>
<tr>
<td></td>
<td>36-45</td>
<td>22.2%</td>
</tr>
<tr>
<td></td>
<td>Greater than 45</td>
<td>19.8%</td>
</tr>
<tr>
<td></td>
<td>Not stated</td>
<td>1.2%</td>
</tr>
<tr>
<td>Position</td>
<td>Junior Accountant</td>
<td>13.6%</td>
</tr>
<tr>
<td></td>
<td>Senior Accountant</td>
<td>16.0%</td>
</tr>
<tr>
<td></td>
<td>Manager</td>
<td>21.0%</td>
</tr>
<tr>
<td></td>
<td>Partner/Director</td>
<td>30.9%</td>
</tr>
<tr>
<td></td>
<td>In-house Account</td>
<td>3.7%</td>
</tr>
<tr>
<td></td>
<td>Lawyer</td>
<td>7%</td>
</tr>
<tr>
<td></td>
<td>Other</td>
<td>7.8%</td>
</tr>
<tr>
<td>Number of years experience</td>
<td>0-1 years</td>
<td>6.2%</td>
</tr>
<tr>
<td></td>
<td>1-3 years</td>
<td>13.6%</td>
</tr>
<tr>
<td></td>
<td>3-6 years</td>
<td>18.5%</td>
</tr>
<tr>
<td></td>
<td>6-10 years</td>
<td>16.0%</td>
</tr>
<tr>
<td></td>
<td>10-15 years</td>
<td>13.6%</td>
</tr>
<tr>
<td></td>
<td>&gt; 15 years</td>
<td>32.1%</td>
</tr>
<tr>
<td>Highest completed education</td>
<td>Below Grade 12</td>
<td>0.0%</td>
</tr>
<tr>
<td></td>
<td>Grade 12</td>
<td>0.0%</td>
</tr>
<tr>
<td></td>
<td>Bachelor</td>
<td>19.8%</td>
</tr>
<tr>
<td></td>
<td>Honours/Masters</td>
<td>17.3%</td>
</tr>
<tr>
<td></td>
<td>CPA/CA</td>
<td>63.0%</td>
</tr>
</tbody>
</table>

106 “Limited liability” refers to the notion that the equity members do not in their capacity as members have full liability exposure for the business operations, and instead their liability is limited to a certain amount.

107 “Prestige” is referring to the notion that the business form itself provides members with a level of credibility in terms of the business operations. Note this factor originates from the findings of Freedman and Godwin, n 55.

108 “Succession planning” is referring to the notion that the business form enables the principal member to allow for family members or third parties (such as employees) to take over control of the business in the future.

109 “Tax benefits/savings” is referring to notion that the business form provides tax planning opportunities to reduce the tax impost on the business income. This could include income sheltering and income splitting.
Accountants made up a large percentage of participants (85%), with only a few lawyers (7%). Accordingly, the findings may be more representative of accountants (as opposed to lawyers) due to the composition of the sample. However, given the substantial role that accountants played in the choice of business form in the Hicks et al study, it may be that the opinions of accountants are insightful.

**Findings**

To ascertain what advisors consider were the most important factors when advising a client about which business form they should utilise, respondents were asked to rank 10 factors from most important to least important. For reporting purposes 10 is used as most important and one as least important.¹¹⁰

On average the most important factor was considered to be asset protection (8.26), which was seen to be more important than tax benefits/savings (6.84), which ranked second: see Figure 1 in the Appendix. This could indicate that, while tax is important, it is not the dominant reason for choosing a business form. This finding would be consistent with the United Kingdom studies that showed the factor of liability protection to be more important than tax reasons, ranking first and second respectively.¹¹¹

Five factors were closely grouped as to their importance (some of which related to liability exposure): business expansion (5.98); level of risk (5.96); limited liability (5.95); CGT concessions (5.68), and succession planning (5.47). The notion of asset protection appears to be more important than limited liability, which may highlight an understanding that the notion of limited liability can be undermined by various circumstances (such as personal guarantees and regulatory obligations).¹¹² Indeed, the notion of limited liability, especially for small businesses, has been described as "largely illusory".¹¹³ What may be more important at the end of the day is protecting valuable assets rather than shielding a person from liability exposure.

Commentators suggest the greater focus on asset protection may be leading to the use of concurrent business forms in Australia, which may have adverse implications in terms of tax compliance cost and complexity.¹¹⁴ The factor of tax compliance cost did not rank highly and was seen as the seventh most important factor (4.49). This may be related to findings that a large percentage of advisors are not aware of empirical evidence about tax compliance cost and business forms.¹¹⁵ This may raise concerns about whether advisors are recommending structures that are too

---

¹¹⁰ Note that on the survey instrument itself, one was “most important” and 10 was “least important” because it was considered the use of “1” would indicate that it was of the upmost importance. However, for reporting purposes, the scale was reversed to give a greater logical representation in the diagram with the largest column symbolising the greatest importance.

¹¹¹ Hicks et al, n 58.

¹¹² For example in the Freedman and Godwin study the effectiveness of the “limited liability” sought in the corporate form was questionable given that the 53.2% of corporate respondents had provided personal guarantees to banks or other creditors (which generally were from directors and/or their spouses): Freedman and Godwin, n 55, p 113. Also, Hicks et al found that in a majority of cases (63%) personal guarantees are signed by those involved in the business, (which is generally from the directors of the corporation in 88% of the time): Hicks et al, n 58, p 15. Of course this personal guarantee does not fully erode limited liability protection as it is just between the guarantor and the bank, leaving other potential creditors recourse against the corporation itself in most cases.

¹¹³ Freedman and Godwin, n 55, p 113.


¹¹⁵ Freudenberg B, Knowing the Beast: To What Extent Do Advisors Understand Compliance Issues about Business Structures?, Paper presented at the 3rd Queensland Tax Researchers’ Symposium, James Cook University (Cairns, 29 June 2012) p 37: only 25% of Queensland advisors were aware of empirical research on how the choice of business form affects tax compliance cost.
complex for clients’ business operations. Research demonstrates there could be different tax compliance cost depending on the business form utilised.\textsuperscript{116}

The raising of equity was the ninth important factor (4.14), which could relate to the fact that many businesses will not go through the expansion phase of the life-cycle model. However, for those businesses that do later seek to expand through raising outside equity, it is questionable to what extent their initial business form is appropriate to facilitate this.

Advisors thought the idea of the “prestige” of the business form was the least important factor (2.21). While this may make sense for the advisor, if the research from the United Kingdom is indicative of the Australian circumstance, it may be that the clients are focused on this factor when other factors are (from their advisors’ point of view) more important.\textsuperscript{117} It is important to appreciate that there may be misunderstanding between advisors and their clients, as advisors need to ensure that their clients are fully aware of the reasons for selecting different business forms.

To explore further the role that tax benefits may play in the choice of business form, advisors were asked to rank which business form gave the greatest tax benefits/savings (ignoring tax compliance cost). In response to this, discretionary trusts were seen as providing the greatest benefit, with an average of 3.81 (on a five-point scale): see Figure 2 in the Appendix. Companies (3.3) and unit trusts (3.16) were considered the second and third best. The ranking of general partnerships as second could support assertions that the complexity of general partnerships in Australia is lower because they have fewer tax planning strategies available to them.\textsuperscript{118} Sole proprietors were seen as providing the least tax benefits/savings of all business forms (2.14).

Consistent with Scholes and Wolfson’s theory, the choice of business form involves a trade off between tax costs and non-tax (transaction) costs.\textsuperscript{119} To this extent the researcher wanted to explore whether the potential for higher tax compliance costs for certain business forms was perceived as offset by the tax benefits available. When asked to consider which business forms’ tax benefits/savings outweighed the compliance costs, discretionary trusts were clearly preferred with the highest average ranking of 3.7, followed by unit trusts (3.34) and then companies (3.20): see Figure 3 in the Appendix. This would indicate that if advisors are aware of the additional tax compliance costs that may be involved with trust structures, they consider that the tax benefits/savings can outweigh this.\textsuperscript{120}

Participants were then asked a number of reflective questions about their clients’ business forms. The majority (68\%) of respondents acknowledged that their clients’ business form could be too complicated for their needs (either sometimes or frequently): see Figure 4 in the Appendix. This may be reflective of the fact that, in the initial advice phase, tax compliance factors were not considered as important as other factors.\textsuperscript{121} There was some ambivalence about whether the tax benefits/savings of their clients’ business forms outweighed the tax compliance costs: approximately half (55\%) thought they did, whereas nearly 40\% did not: see Figure 5 in the Appendix.

However, there was an overwhelming refutation of the assertion that advisors are too focused on tax savings at the expense of increased compliance costs, since 75.6\% disagreed with the statement “Accountants and business advisors are too focused on tax savings rather than on the tax compliance costs that business forms can impose on their clients”. This would confirm the finding that “tax benefits/savings” was not the top consideration for business formation: instead, this was asset protection.


\textsuperscript{117} Note in the United Kingdom studies, there was a feeling from the respondents that a corporation was in some way “more serious and trustworthy” than the sole proprietor or general partnership: Freedman and Godwin, n 55, p 114.


\textsuperscript{119} Scholes and Wolfson, n 81.

\textsuperscript{120} Evans et al, n 116.

\textsuperscript{121} Refer to Figure 1 in the Appendix.
LIMITATIONS AND FUTURE RESEARCH

It is acknowledged that this research had only a small sample size and may have jurisdictional bias because only Queensland advisors were surveyed. However, given the national application of business forms and income tax, the sampling of Queensland advisors may not constitute a significant bias.

Also, there was a high proportion of accountants in the survey, and their opinions may not be reflective of other professions (particularly lawyers) involved in giving advice about business formation. However, it is contended that the study provides a foundation on which future research could probe this distinction further.

Future research could consider which are the factors (and their importance) for choice of business form, from the advisors’ and clients’ perspectives. This could include any differences between professions (such as accounting and the law), as well as between client experience levels (such as sophisticated/previous experience and unsophisticated). This could also include whether the size of the proposed business operations affects the choice of business form. Future research also could consider the life-cycle model and which factors in choosing business form may have costs that inhibit the growth of a business. For example, to what extent do stamp duty and CGT adversely impact on the changing of business forms? Another consideration is whether asset protection strategies increase tax compliance costs. For example, what is the effect of the concurrent use of business forms, where a focus on asset protection may impose legacy costs that make some actions difficult, such as unwinding the business or attracting equity.

Future research could consider the extent to which formal advice is obtained in the formation of a business (and from whom): for example, what factors were considered; whether tailored governance documents were obtained; what are the characteristics that lead to greater satisfaction with the choice; and are some business forms more accommodating to the life-cycle needs of a business? Such research could explore whether there is a link between tax benefits as the dominant reason for business form choice and the later dissatisfaction with the choice made.

CONCLUSION

There are various different business forms available in Australia. Choosing among them is important because the choice could influence future issues for the business. To try to ascertain what factors are important, a survey of professional advisors was undertaken. The findings tend to indicate that of the 10 factors surveyed, asset protection and tax benefits/savings are the most important when providing advice about business forms. It would appear that tax benefits, while important, do not play the dominant role in the choice of business form. This may alleviate concerns that tax benefits play too great a role in the choice of form even though there is such diversity of tax treatment in Australia.

However, the focus on asset protection may be leading to practices which can add regulatory and tax compliance burdens, such as the concurrent use of business forms. For example, Lehmann has acknowledged that the consolidation regime for income tax on companies can in part be attributed to the use of concurrent business forms. However, Lehmann queried what sympathy there should be when this arises because businesses set up complex structures to minimise tax or to frustrate creditors.123 Indeed, the low consideration given to tax compliance factors in recommending business forms may result in advisors recommending structures that are too complex for their clients’ needs, something acknowledged by nearly 70% of participants. However, it would appear that advisors consider that the tax benefits of a business form can outweigh any additional tax compliance cost.

It is important that future research explores the important decision-making process that occurs on the formation of a business to gain a greater understanding about this foundation decision and whether there are certain factors that lead to greater satisfaction with the choice. It is possible that improved choice of business form could have positive implications for the business itself and the economy as a whole.

123 Lehmann, n 114, pp 291-292. Lehmann identified that small business may adopt complex structures also for family tax planning and asset protection.
FIGURE 1  Ranking of factors of business form advice

(10=most important, 1=least important) Averages given of responses – inversed on initial ranking as on survey document “1” was most important
FIGURE 2  Ranking of tax benefits of business forms

(Average ranking score where 1= the lowest and 5=the highest)

FIGURE 3  Ranking of tax benefits outweighing compliance cost of business forms

(Average ranking score where 1= the lowest and 5=the highest)
FIGURE 4  Client business form too complicated

- Frequently, 9.7%
- Never, 1.4%
- Seldom, 22.2%
- Unsure, 8.3%
- Sometimes, 58.3%

FIGURE 5  Tax benefits of client business form outweigh tax compliance cost

- Frequently, 11.3%
- Never, 5.6%
- Seldom, 32.4%
- Unsure, 7.0%
- Sometimes, 43.7%