Tax on my mind: Advisors’ considerations for business formation

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Abstract

The research detailed in this paper has two aims. Firstly, to better explore what advisors consider are important factors in the choice of business form. Secondly, to gauge an understanding of whether tax benefits plays a large role in this choice. A better understanding of the process of choosing an appropriate business form is needed, as making the wrong choice may result in economic inefficiencies for both the business and the broader economy.

This paper details a study of 81 Queensland advisors that explored what they thought were important considerations regarding the formation of businesses. The findings suggest of the 10 factors surveyed that advisors consider the factors of asset protection and tax benefits, to be most important when providing recommendations about business forms.
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**Section One**

1.1 *Introduction*

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

While there are a number of 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 transferable membership interests.⁴ Countries such as Australia see the use of the corporation as inevitably linked to their future economic

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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).
prosperity, with governments encouraging incorporation through lowering of the 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.\(^6\) Although the most frequently used form is that of sole proprietor which technically is not a separate legal form.

When initially deciding upon which business form to adopt, what are the factors to be considered? Some argue that if tax benefits dominate this it may lead to poor decisions. The Henry Review reiterated this adverse affect:

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 the extent which taxes or other regulatory policies interfere with the achievement of the most efficient business form, real costs could be imposed on the economy.\(^8\) Such inefficiencies could relate to greater regulatory compliance burden than is necessary given the scale of the business operations.

This paper details a study of the considerations of advisors when they recommend a business form, such as the factors that they think are central to their advice. While the

\(^5\) For example, this is reflected by the decrease of corporation registration fees by 50 per cent to in the Federal Budget in approximately 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.

\(^7\) Australia, Australia’s Future Tax System – Consultation Paper (Henry K - Chairman, Attorney-General’s Department, Barton, 2008) p 153.

research does not measure the possible inefficiencies of the choice of business form it does highlight that of the ten factors surveyed the two most important are asset protection and tax benefits. Also nearly 70 per cent of advisors acknowledge that the business forms recommended may be too complicated for their clients’ needs.

Section Two of this paper demonstrates that there are a number of business forms that are available in Australia with varying tax treatment. The third section outlines overseas studies that demonstrate 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. Section Four outlines the methodology adopted in this study and gives the results. The final section suggests future research, before concluding.

**Section Two**

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

### 2.1 Possible business forms

When commencing a business in Australia there are a number of possible business forms, including sole proprietors, 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 form having neither a separate legal entity nor perpetual succession. Sole proprietors

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9 It should be noted that some of the business forms listed are not technically ‘separate business form’, such as: 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 paper.
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 per cent for taxable income over $180,000.

Normally, the general partnership will be governed by a Partnership Agreement and by the state Partnership Acts,¹¹ which detail such things as management rights, profit sharing¹² 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’.¹³ Additionally, under partnership law, the default rules assume that all the partners will be active participants in the management of the enterprise.

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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.

¹¹ Partnership Act 1892 (NSW), Partnership Act 1958 (Vic), Partnership Act 1891 (SA), partnership Act 1891 (Qld), Partnership Act 1895 (WA), Partnership Act 1891 (Tas), Partnership Act 1963 (ACT), Partnership Act 1997 (NT).

¹² 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.

¹³ 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.
A general partnership must have at least two members, with the number of members limited to twenty partners\textsuperscript{14} unless the consent of the relevant Minister is obtained. Once the number of partners exceeds twenty, the business form must incorporate.\textsuperscript{15}

The general partnership does not provide for any limitation of liability for members, as 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.\textsuperscript{16} 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.\textsuperscript{17}

Members’ interests in a general partnership are not freely transferable. Pursuant to the various Australian state \textit{Partnerships Acts}, no partner may transfer his or her share to render the transferee a partner without the consent of all existing partners.\textsuperscript{18} 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 members.\textsuperscript{19}

\footnotesize{
\begin{itemize}
  \item[\textsuperscript{14}] \textit{Corporations Act 2001 (Cth)}, s 115.
  \item[\textsuperscript{15}] However, certain types of general partnerships are allowed to operate with more than twenty partners, including law firms and accountancy firms.
  \item[\textsuperscript{16}] \textit{Partnership Act 1892 (NSW)}, s 9; \textit{Partnership Act 1958 (Vic)}, s 13; \textit{Partnership Act 1891 (SA)}, s 9; \textit{Partnership Act 1891 (Qld)}, s 12; \textit{Partnership Act 1895 (WA)}, s 16; \textit{Partnership Act 1891 (Tas)}, s 14; \textit{Partnership Act 1963 (ACT)}, s 13; \textit{Partnership Act 1997 (NT)}, s 13. Though the partner could sue under contract the other partners.
  \item[\textsuperscript{17}] \textit{Partnership Act 1892 (NSW)}, s 10(1); \textit{Partnership Act 1958 (Vic)}, s 14(1); \textit{Partnership Act 1891 (SA)}, s 10; \textit{Partnership Act 1891 (Qld)}, s 13; \textit{Partnership Act 1895 (WA)}, s 17; \textit{Partnership Act 1891 (Tas)}, s 15; \textit{Partnership Act 1963 (ACT)}, s 14; \textit{Partnership Act 1997 (NT)}, s 14.
  \item[\textsuperscript{18}] \textit{Partnership Act 1892 (NSW)}, s 24(7); \textit{Partnership Act 1958 (Vic)}, s 28(7); \textit{Partnership Act 1891 (SA)}, s 24(g); \textit{Partnership Act 1891 (Qld)}, s 27(g); \textit{Partnership Act 1895 (WA)}, s 34(6); \textit{Partnership Act 1891 (Tas)}, s 29(g); \textit{Partnership Act 1963 (ACT)}, s 29(7); \textit{Partnership Act 1997 (NT)}, s 28(g).
\end{itemize}
}
A general partnership is subject to tax flow-through, with members paying tax in accordance with their individual shares of the net partnership income or loss.\textsuperscript{20}

In Australia there are also limited partnerships which are not bodies corporate and which do not have separate legal status for members.\textsuperscript{21} The personal liability of all members, except for one,\textsuperscript{22} may be limited to the amount of capital contributed by them to the limited partnership.\textsuperscript{23} However, these limited partners are generally precluded from taking part in the management of the business and have no power to bind the business.\textsuperscript{24} The limited partnership\textsuperscript{25} is taxed as a corporation in Australia, which is described below.\textsuperscript{26}

Corporations limited by shares are the most common form of corporation in Australia, and they provide for a separate legal entity and limited liability for members.\textsuperscript{27} 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

\textsuperscript{20} ITAA 1936 (Cth), s 92.
\textsuperscript{21} 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 1908 (Tas), s 4(2).
\textsuperscript{22} 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.
\textsuperscript{23} 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 1908 (Tas), s 4(2).
\textsuperscript{24} 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) and 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) and Limited Partnerships Act 1908 (Tas), s 6(3).
\textsuperscript{25} 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 VCLP, an AFOF or a VCMP and to carry on activities that are carried on by a body of that kind: ITAA 1997 (Cth), s 995-1.
\textsuperscript{26} The flow-through treatment of limited partnerships was eliminated by the introduction of ITAA 1936 (Cth), Division 5A with limited partnerships being defined as 'corporate limited partnerships'.
\textsuperscript{27} 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.
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, in the
corporation. However, there are circumstances when a member’s liability will not be
limited, and the courts will ‘lift the corporate veil’. 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 Law
2001 (Cth), or personal guarantees may be required by creditors.

Australia has adopted an imputation system for the taxation of corporations 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. Franked dividends are those paid from profits that have
borne corporation tax. Currently, the corporate tax rate in Australia is 30 per cent.

Another possible business form, trusts, can be considered more of a relationship
between trustees and beneficiaries rather than as a separate business form. Trustees
are governed essentially by three things: the trust instrument, the State and Territory
Legislation, and the trustee’s fiduciary obligations. The precise powers detailed in

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28 For example: Giford Motor Co Ltd v Horne [1933] Ch 935.
29 For example: Corporations Law 2001 (Cth), s 180: exercise reasonable care and diligence.
30 This includes corporate limited partnership [except for the tightly regulated venture capital
incorporated limited partnerships: ITAA 1936 (Cth), s 94D (2)] and public unit trusts.
31 ITAA 1997 (Cth), s 207-20.
32 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.
33 Also known as the trust deed.
34 Note each State and Territory in Australia has its own Trust Act. These are the Trusts Act 1973 (Qd),
Trustee Act 1958 (Vic), Trustee Act 1925 (NSW), Trustee Act 1936 (SA), Trustee Act 1898 (Tas), Trustee Act 1962 (WA), Trustee Act 1925 (ACT) and Trustee Act 1893 (NT).
35 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 (Qd), s 4; Trustee Act 1958 (Vic), s 2(3); Trustee Act 1925 (NSW), s 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
a trust’s instrument will vary significantly from trust to trust, though in modern trust instruments the trustee’s powers are widely drafted.

Types of trusts can be distinguished in several ways, including when and how they were established, 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. An example of a fixed trust is a unit trust, 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.

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. 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.\textsuperscript{41}

In Australia all trusts established, except those in South Australia, have to vest\textsuperscript{42} 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’, whereas unit holders in a unit trust can.\textsuperscript{43}

Trusts are subject to only a partial tax flow-through system: income can be assessed directly to members (beneficiaries) but losses are confined within the trusts themselves. Tax preferences do not always flow through to beneficiaries, as a conduit principle may apply to distributions provided sufficient records are maintained.\textsuperscript{44} Such a conduit principle means that trust receipts retain their character in the hands of the beneficiary,\textsuperscript{45} thereby enabling beneficiaries to take advantage of concessional treatment applying to different receipts.\textsuperscript{46} Beneficiaries who are presently entitled to

\textsuperscript{41} JW Broomhead (Vic) Pty Ltd v JW Broomhead Pty Ltd [1985] VR 891.
\textsuperscript{42} The corporate equivalent would be ‘wound-up’.
\textsuperscript{43} 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 \textit{Gartside v Inland Revenue Commissioners} [1968] AC 553; [1968] 1 All ER 121 and \textit{Chief Commissioner of Stamp Duties (NSW) v Buckle} (1998) 192 CLR 226; 72 ALJR 243; 98 ATC 4103. For a thorough discussion of the nature of discretionary beneficiaries’ interest see: Freudenberg B and McDermott P, “The Forgotten CGT events: Are asset revaluations reserve distributions by trustees of discretionary trusts taxable?” (2005) 34(2) Australian Tax Review 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.
\textsuperscript{44} Bamford v Commissioner of Taxation (2010) 240 CLR 481; and Schedule 2 of the \textit{Tax Laws Amendment (2011 Measures No 5) Act 2011} (Cth).
\textsuperscript{45} 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 B and McDermott P, “The Forgotten CGT events: Are asset revaluations reserve distributions by trustees of discretionary trusts taxable?” (2005) 34(2) Australian Tax Review 67.
\textsuperscript{46} In some circumstances the flow-through of tax preferences will be tax free receipts for beneficiaries. For example when accounting income exceeds taxable income: Freudenberg B, “Are asset revaluation reserve distributions ‘ordinary income’ for discretionary beneficiaries?” (2005) 20(1) Australian Tax
the income of the trust are taxable on their respective share of the trust’s net income.\(^{47}\)

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.

2.2 *Utilisation of business forms*

To gain an understanding to what extent the different business forms are made use of 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 per cent were sole proprietors, 27 per cent corporations, 24 per cent trusts and 13 per cent partnerships: Table 1.

**Table 1: AUS: 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><strong>Total</strong></td>
<td>2,737,877</td>
<td>2,910,376</td>
<td>2,820,868</td>
<td>2,906,073</td>
</tr>
</tbody>
</table>

Source: Australian Taxation Office, *Taxation Statistics: A summary of tax returns for the 2006 to 2010 income years* (Australian Taxation Office, Canberra, 2012). *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: Table 3.10, p 26.

In terms of size, 99.9 per cent 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 Australian Taxation Office (ATO) as ‘small’), 45 per cent are sole proprietors, 28 per cent corporations, 14 per cent

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\(^{47}\) *ITAA 1936* (Cth), 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.
partnerships and 13 per cent trusts. According to the statistics for the Australian Business Numbers, there are currently 2,684 limited partnerships registered for a business number.\textsuperscript{48} For taxpayers with business income greater than $10 million, the corporation is the most popular (73 per cent), followed by trusts (19 per cent), partnerships (5 per cent) and sole proprietors (2 per cent): Table 2.

### Table 2: AUS: 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><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Australian Taxation Office, Taxation Statistics: A summary of tax returns for the 2006 to 2010 income years (Australian Taxation Office, Canberra, 2012), Table 1.3: Data processed up to 31 October 2011.

While each business form has been discussed separately, it is simplistic to consider the business forms in isolation of each other, for in practice often a combination of business forms (concurrent use) is used in the one business venture to achieve desired qualities related to tax and non-tax attributes, such as improved asset protection\textsuperscript{49} and the sharing of losses.\textsuperscript{50} The Australian government recognises this concurrent use of business forms and has allowed, for example, general partnerships


\textsuperscript{49} 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.

\textsuperscript{50} 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.
and trusts to be part of a consolidated group of corporations, and has also allowed the small business capital gains tax (CGT) concessions that applies to the renting of assets between related entities to be still regarded as ‘active’.

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.

**Section Three**

The issues affecting the selection of business forms are numerous and complex. One is the consideration of the regulatory burdens that are owing to governing statutes, industry practice, ability to raise finance and the ability of clients to understand them. 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 suggest 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 as 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.

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52 ITAA 1997 (Cth), s 154-40.
### 3.1 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 business 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’.\(^{56}\) Their reasoning is that the choice of business forms is not governed by factors such as size, assets or management structure.\(^{57}\) 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.\(^{58}\)

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’.\(^{59}\)

However, it is questionable to what extent complete advice is obtained at the time of formation of the business.\(^{60}\) 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

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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, as 70 per cent of corporations were formed by accountants, 13 per cent by company registration agents and only 12 per cent by solicitors. How well considered these incorporation processes were is questionable, as formal advice was only sought in 36 per cent of cases, and 97 per cent of that advice was from accountants, with the remaining 3 per cent from solicitors.

With those United Kingdom businesses utilising the general partnership form, only 43 per cent had a formal partnership agreement. Unlike corporations, solicitors played a larger role in general partnerships, as 85 per cent of these were drawn up by a solicitor, and 15 per cent by an accountant. The difference between corporations and general partnerships may have to do with reforms that make setting up a

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63 Hicks A, Drury R and Smallcombe J, Alternative Company Structures for the Small Business (ACCA Research Report No 42) (Certified Accountants Educational Trust, London, 1995). The method adopted was a combination of extensive questionnaires followed by in-depth face-to-face interviews. This resulted in 152 completed responses from businesses and interviews with 30 advisors across England. In terms of business forms, there were 32 sole proprietors represented, 30 partners and 90 directors of corporations. The advisors were 16 accountants, 10 lawyers and four business advisors.
corporation relatively easy, so that no legal qualification is required to purchase the corporate shell. For sole proprietors, when formal advice was obtained, 50 per cent was from accountants and 30 per cent from solicitors.\textsuperscript{68}

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’.\textsuperscript{69} It is suggested that Australia could be similar, in relation to the accountant being dominant in the role of giving business form advice, particularly when businesses are starting off.

In terms of receiving formal advice there was a strong similarity between corporations, general partnerships and sole proprietors, as in approximately one-third of circumstances formal advice was obtained.\textsuperscript{70} That means for two-thirds of the time, 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 Godwin\textsuperscript{71} supports these findings, as they found a lack of ‘tailoring’ of the corporate form to any individual needs: only eight per cent reported that articles (constitution) were tailored to their own requirements.\textsuperscript{72} The found only 25

\begin{flushleft}
\textsuperscript{70} For corporations it was: 36 per cent of cases; general partnerships: 36.6 per cent and sole proprietors: 31 per cent.
\textsuperscript{71} Freedman J and Godwin conducted a survey in the early 1990's in the United Kingdom. They survey 429 firms, conducted 24 face-to-face interviews with small businesses, and 12 with auditors. While they didn’t 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 J and Godwin M, “Incorporating the Micro Business: Perceptions and Misperceptions” in Hughes A and Storey D (eds), \textit{Finance and the Small Firm} (Routledge, London, 1994) p 108.
\end{flushleft}
per cent indicated that they had a standard form documentation with a few changes; 75 per cent believed they had just an off-the-shelf standard form.\(^{73}\)

Such findings are supported by a New Zealand study that questions whether the development of standard form constitutions by the market has occurred in a meaningful way. The review by Dugan et al. of corporation constitutions concluded that the constitutions were ‘replete with redundant material, errors and ambiguities and revealed no serious attempt to adopt the rules of the Act to the circumstances.’\(^{74}\) This could reflect the possibility that small business cannot afford to pay for tailored rules at the set-up stage, or perceive it to be too expensive,

The findings overseas appear to have resonance in Australia, as an OECD study of Australian businesses found that 59 to 69 per cent of businesses had trouble understanding regulations.\(^{75}\) It appears that small business owners often have a poor understanding of regulatory requirements, with 62 to 75 per cent of businesses stating it is not possible to comply with all the regulations they should.\(^{76}\) For example, even with the improvements of the \textit{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.\(^{77}\) 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 this may not be comprehensive.

### 3.2 Breaches of tax neutrality

Concerns have also been raised about tax benefits 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 commercial considerations to avoid inefficiencies, rather than having tax dominate the decision.\(^78\) These arguments are based on the notion of tax neutrality. That is, regardless of the business form adopted, the tax burden should be equivalent.\(^79\) 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.\(^80\) However, as already canvassed, the tax treatment of business forms in Australia is not neutral.

Tax can be seen as 'driving a wedge' between the gross return on an investment and the net return after taxes on the savings used to finance that investment.\(^81\) Theoretically, this 'tax wedge' should be the same, irrespective of the business form adopted, on the basis of facilitating the principle 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

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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 motivated 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 profits 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 through this.

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 of America (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

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84 For example: FCT v Gulland; Watson v FCT; Pincus v FCT (1985) 160 CLR 55; Tupicoff v FCT (1984) 56 ALR 151; and Case 2/2004 AATA 349.
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, as the S Corporation could provide the benefits of a corporate characteristics but 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.

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. 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 and this is entirely understandable given the flow-through of consequent 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): Table 3. However, for advisors, tax was the second most important factor, whereas for those without advice, ‘prestige’ was the second most important. Consequently, it appears that advisors give

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88 Holub M, *Taxes and the Choice of Organisational Form in Australia* (PhD, Department of Accounting and Finance, University of Western Australia, 2001).
91 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.
greater weighting to tax consideration when providing advice about whether to incorporate or not – although it is not the dominant reason.

Table 3: UK: Reasons for incorporating

<table>
<thead>
<tr>
<th>Reason</th>
<th>Reasons given by advisors to clients</th>
<th>Directors reasons (when no advice obtain)</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>6%</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>0</td>
<td>6%</td>
</tr>
<tr>
<td>Number of respondents</td>
<td>32</td>
<td>56</td>
</tr>
<tr>
<td>Missing</td>
<td></td>
<td></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 (i.e. sole proprietors and general partnerships), that personal control was a major reason in the choice of business form (87 per cent for sole proprietors; 67 per cent for partnerships): 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 per cent for sole proprietors).\(^{92}\) However, tax did play a part, as 39 per cent indicated that tax was an important reason in their choice.\(^{93}\)

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Table 4: UK: 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 per cent thought that prestige/creditability was part of their reasoning: Table 5. The third most important reason (38 per cent) related to the tax implications of their choice.

Interestingly, Freedman and Goodwin found that there was a group of dissatisfied businesses that had incorporated owing to the pressure from agencies or businesses that they generally contracted with. The reason for this enforced incorporation was in part to avoid labour [tax] costs and the shifting of risk (such as sickness and injury) and to offer the ease to terminate the contract on short notice. This may suggest that those who been forced to adopt a certain business form may be unsatisfied with the outcomes of their selection.

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Table 5: UK: 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/credibility (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.\(^{96}\) 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.\(^ {97}\) He found that seven of the eight public unit trusts studied chose to re-organise/re-constitute to a corporation after the government amendments.\(^ {98}\) 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.\(^ {99}\)

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,

\(^ {96}\) ITAA 1936 (Cth), Division 6C: enacted in 1985.  
\(^ {97}\) Holub M, Taxes and the Choice of Organisational Form in Australia (PhD, Department of Accounting and Finance, University of Western Australia, 2001) p 328.  
\(^ {98}\) Holub observed that high reorganisational 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.  
\(^ {99}\) Holub M, Taxes and the Choice of Organisational Form in Australia (PhD, Department of Accounting and Finance, University of Western Australia, 2001) p 330.
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 the business should ignore the potential tax implications of their business form choice; instead, concern is raised when tax is the dominant reason, as 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 per cent 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.\(^\text{100}\)

This may indicate that having tax as the dominant consideration for the choice of business form may lead to dissatisfaction with the choice of form. It is for this reason research was undertaken to gain a greater understanding of the factors considered when choosing a business form.

**Section Four**

The research detailed in this paper had two aims. Firstly, to better explore what advisors consider are the important factors in the choice of business form. Secondly, to gauge an understanding of whether tax benefits plays 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 paper. 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

& Godwin\textsuperscript{101} and Hicks et al.\textsuperscript{102}) and from the literature in the area (such as Porcaro).\textsuperscript{103} The list was initially pilot tested and refined. The final list of factors consisted of the following: asset protection;\textsuperscript{104} business expansion;\textsuperscript{105} CGT concessions;\textsuperscript{106} compliance cost;\textsuperscript{107} equity raising;\textsuperscript{108} level of risk;\textsuperscript{109} limited liability;\textsuperscript{110} prestige;\textsuperscript{111} succession planning;\textsuperscript{112} and tax benefits/savings.\textsuperscript{113}

To facilitate data collection, a survey was conducted of 81 advisors in Queensland attending six continuing professional development (CPD) seminars conducted by the Tax Institute. Approximately 240 advisors were in attendance at these seminars. The Taxation Institute is a professional body representing tax practitioners; the CPD

\textsuperscript{104} ‘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. Such as from creditors or tortfeasors.
\textsuperscript{105} ‘Business expansion’ is referring to the notion that the business forms provides for the ability to allow the business operations to grow. This can cover notions that the business form is recognised internationally, is accepted by banks to facilitate borrowing and allows for the introduction of other equity members.
\textsuperscript{106} ‘CGT Concessions’ refers to the concessional treatment provided to capital gains pursuant to the Income Tax Assessment Act 1997 (Cth), including the 50 per cent discount for CGT assets held greater than 12 months and the small business CGT concessions.
\textsuperscript{107} ‘Compliance cost’ is referring to both the regulatory and tax compliance cost that may be imposed by a business form. For example, corporations are required to be incorporated and then having general annual filing requirements.
\textsuperscript{108} ‘Equity raising’ refers to the concept that the business form provides the ability to attract additional equity members.
\textsuperscript{109} ‘Level of risk’ is referring to the notion that some business operations or activities may involve a greater level of risk.
\textsuperscript{110} ‘Limited liability’ refers to the notion that the equity members of the business do not legally in their capacity as members have full liability exposure for the business operations, and instead their liability is limited to a certain amount.
\textsuperscript{111} ‘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 J and Godwin M, “Incorporating the Micro Business: Perceptions and Misperceptions” in Hughes A and Storey D (eds), Finance and the Small Firm (Routledge, London, 1994).
\textsuperscript{112} ‘Succession planning’ is referring to the notion that the business form enables for the principal member to allow for fellow family members or third parties (such as employees) to take over control of the business in the future.
\textsuperscript{113} ‘Tax benefits/savings’ is referring to notion that the business form provides tax planning opportunities to reduce the tax impost on the business profits.
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.

5.1 Descriptive statistics

Table 1 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.

Accountants made up a large percentage of participants (85 per cent), with only a few lawyers (seven per cent). 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 to the considerations at play.
Table 6: Demographics of participants

<table>
<thead>
<tr>
<th>Variable</th>
<th>Factors</th>
<th>Values</th>
</tr>
</thead>
<tbody>
<tr>
<td>N</td>
<td></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>

5.1 Findings

To ascertain what advisors consider were the most important factors when advising a client about what business form they should utilise, respondents were asked to rank ten factors from most important to least important. For reporting purposes ten is used as most important and one as least important.\textsuperscript{114}

\textsuperscript{114} Note on the survey instrument itself one was most important and ten least important, as it was consider the use of ‘1’ would indicate that it was of the upmost importance. However, for reporting purposing the scale was reversed to give a greater logical representation in the diagram with the largest column representing the greatest importance.
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: Figure 1. 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.

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).\textsuperscript{115} Indeed, the notion of limited liability, especially for small businesses, has been described as ‘largely illusory’.\textsuperscript{116} 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.\textsuperscript{117}

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\textsuperscript{115} 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 per cent of corporate respondents had provided personal guarantees to banks or other creditors (which generally were from directors and/or their spouses): Freedman J and Godwin M, “Incorporating the Micro Business: Perceptions and Misperceptions” in Hughes A and Storey D (eds), \textit{Finance and the Small Firm} (Routledge, London, 1994) p 113. Also, Hicks et al. found that in a majority of cases (63 per cent) personal guarantees are signed by those involved in the business, (which is generally from the directors of the corporation in 88 per cent of the time): Hicks A, Drury R and Smallcombe J, \textit{Alternative Company Structures for the Small Business} (ACCA Research Report No 42) (Certified Accountants Educational Trust, London, 1995) 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.


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.)
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.\textsuperscript{118} This may raise concerns about whether advisors are recommending structures that are too complex for clients’ business operations, especially as research demonstrates there could be different tax compliance cost depending on the business form utilised.\textsuperscript{119}

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 may be 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 of factors (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{120} It is important to appreciate that there may be misunderstanding between advisors and their clients, as advisors need to ensure that their clients are

\begin{flushright}
\textsuperscript{118} Freudenberg, B. (2012). ‘Knowing the beast: to what extent do advisors understand compliance issues about business structures?’ Paper presented at the $3^{rd}$ Queensland Tax Researchers’ Symposium, James Cook University, Cairns, 29 June 2012, at p 37: only 25\% of Queensland advisors were aware of empirical research on how the choice of business form affects tax compliance cost.

\textsuperscript{119} Evans C, Ritchie K, Tran-Nam B and Walpole M, A Report into the Incremental Costs of Taxpayer Compliance (AGPS, Canberra, 1996).

\textsuperscript{120} 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 J and Godwin M, “Incorporating the Micro Business: Perceptions and Misperceptions” in Hughes A and Storey D (eds), Finance and the Small Firm (Routledge, London, 1994) p 114.
\end{flushright}
fully aware of the considerations they are undertaking when advising on 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), discretionary trusts were seen as providing the greatest benefit, with an average of 3.81 (on a 5 point scale): Figure 2. Companies (3.3) and unit trusts (3.16) were considered the second and third best. Ranking of general partnerships as second could appear to support assertions that the complexity of general partnerships in Australia is lower because they have fewer tax planning strategies available to them.\textsuperscript{121} Sole proprietors were seen as providing the least tax benefits/savings of all business forms (2.14).

\textbf{Figure 2: Ranking of tax benefits of business forms}

![Bar chart showing rankings of business forms]

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

Consistent with Scholes and Wolfson’s theory the choice of business forms involves a trade off between tax costs and non-tax (transaction) costs,\textsuperscript{122} to this extent the researcher wanted to explore whether the potential for higher 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 (3.7), followed by unit trusts (3.34) and then companies (3.20): Figure 3. 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 provided by these structures outweigh this.\textsuperscript{123}

\textbf{Figure 3: Ranking of tax benefits outweighing compliance cost of business forms}

\begin{center}
\begin{tabular}{c|c}
Business Form & Average Ranking Score \\
\hline
Sole proprietor & 2.14 \\
General Partnership & 2.63 \\
Company & 3.20 \\
Unit Trust & 3.34 \\
Discretionary Trust & 3.70 \\
\end{tabular}
\end{center}

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

\textsuperscript{122} Scholes MS and Wolfson MA, \textit{Taxes and Business Strategy: A Planning Approach} (Prentice-Hall Inc, New Jersey, 1992)

\textsuperscript{123} Evans C, Ritchie K, Tran-Nam B and Walpole M, \textit{A Report into the Incremental Costs of Taxpayer Compliance} (AGPS, Canberra, 1996).
Participants were then asked a number of reflective questions about their clients’ business forms. The majority (68 per cent) of respondents acknowledged that their clients’ business form could be too complicated for their needs (either sometimes or frequently): Figure 4. This may be reflective of the fact that, in the initial advice phase, tax compliance factors are low on the list of importance.\textsuperscript{124} There was some ambivalence about whether the tax benefits/savings of their clients’ business forms outweighed the tax compliance costs: approximately half (55 per cent) thought they did; whereas nearly 40 per cent did not: Figure 5.

**Figure 4: Client business form too complicated**

![Graph showing percentage of respondents for different levels of complexity of business forms.](image)

However, there was an overwhelming refutation of the assertion that advisors are too focused on tax savings at the expense of increased compliance costs, as 75.6 per cent disagreed with the statement ‘Accountants and business advisors are too focused on tax savings rather than on the tax

\textsuperscript{124} Refer to Figure 1.
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, asset protection was: Figure 1. However, this begs the question whether the focus on asset protection is a cause of increased tax compliance cost.

Figure 5: Tax benefits of client business form outweigh tax compliance cost

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Frequently</td>
<td>11.3%</td>
</tr>
<tr>
<td>Seldom</td>
<td>32.4%</td>
</tr>
<tr>
<td>Sometimes</td>
<td>43.7%</td>
</tr>
<tr>
<td>Unsure</td>
<td>7.0%</td>
</tr>
<tr>
<td>Never</td>
<td>5.6%</td>
</tr>
</tbody>
</table>

Section Five

This section highlights the limitations of this research, as well as noting the potential for future research.

5.1 Limitations and future research

It is acknowledged that this research has only a small sample size and may have jurisdictional bias as only Queensland advisors were surveyed. However, given the national application of business forms and issues of 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 professionals (particularly lawyers) involved in giving advice about business formation. However, it is contended that the study provides a foundation on which future research can be tested and built upon.

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 types (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 could consider the life-cycle model and which factors of choosing business form may have historical costs that may inhibit the evolution of a business form. For example, to what extent do stamp duty and CGT adversely impact on the changing of business form?

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 imposes 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 a more satisfied result with the choice, and are some business forms more accommodative 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.

### 5.2 Conclusion

There are a number of different business forms are available in Australia. Choosing among them is important as 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 tax compliance cost is not an important factor when considering choice of business form – asset protection and tax benefits/savings are most important.

The focus on asset protection may be leading to the concurrent use of business forms, which can add regulatory and tax compliance burdens. For example, Lehmann has acknowledged that the consolidation regime for the corporations’ tax, which has been criticised as being too complex for small businesses, can in part be attributed to the use of concurrent business forms. However, Lehmann queries what sympathy there should be when this arises because businesses set up complex structures to minimize tax or to frustrate creditors. The low consideration of tax compliance factors may result in advisors recommending structures that are too complex for their client’s needs, something acknowledged by nearly 70 per cent 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.