CHARTERED ACCOUNTANTS
PHYSICAL 1st FLOOR, 67 FLORIDA ROAD, DURBAN, KWAZULU NATAL, SOUTH AFRICA
POSTAL PO BOX 48619, QUALBERT 4078
TEL + 27 31 303 6130 FAX + 27 31 303 4399
EMAIL global@sjcasa.co.za WEB www.sjcasa.co.za

MoneyTalk

Deciding on a legal structure for a business

WHEN starting a business venture or acquiring commercial property, the appropriate legal structure that will house such an operation or asset has to be carefully thought out and decided upfront. Bennie Botha, tax specialist at PricewaterhouseCoopers (PwC), says this initial decision is crucial and there are various factors ranging from taxation to personal liability to consider.

Botha says that conducting a business through a company or trust has always been an attractive route as one avoids being personally liable for the debts of the business if it goes insolvent. But this protection is not unlimited and a court can declare managers and directors personally liable, without limitation, for the company's debts, if they have traded recklessly or fraudulently.

If a commercial property is being acquired, Botha highlights that the three usual options here are holding the property in:

- One's personal name as an individual.
- A company where one is both a director and shareholder.
- A trust (usually a discretionary trust) of which one is both a trustee and beneficiary.

Taxation will always be an important factor in determining the optimal legal structure. A limited company pays Income tax at 29 per cent, capital gains tax (CGT) at 14.5 per cent, and secondary tax(STC) at 12,5 per cent on net dividends declared to shareholders. Small Business Corporations pay income tax at rates between 0 and 29 per cent and CGT at rates between 0 and 14,5 per cent. The STC rate will reduce to 10 per cent on 1 October 2007.

Trusts pay income tax at a flat rate of 40 per cent. CGT is at 20 per cent but this applies only if the gain is not distributed to beneficiaries, and is taxed within the trust. A material tax advantage of trusts not available to companies is that a gain can be distributed to a trust beneficiary and taxed in his hands at the beneficiary's rate of tax, which could even be zero depending on his tax position.

Botha says that estate duty, a form of tax, is often ignored. A trust, like a company, effectively has an unlimited life and does not pay estate duty. In a discretionary trust, the expected interest of a beneficiary has no value for estate duty purposes. By contrast, although a company itself does not pay estate duty, an individual who holds shares will pay estate duty on the value of his shares on death.

Corporate governance also needs to be considered. Companies have well-established rules governing relationships between directors and shareholders and regulations protect minority owners. Shareholders can also form voting coalitions. Trusts generally do not have these advantages and problematic disputes could arise.

Where several businesses are being conducted or operations are expanding, a company structure is often advantageous as takeovers, mergers and changes in ownership (such as incoming BEE partners) can be more easily facilitated. There is also tax relief available for rationalisations and various restructurings.

A further variation in structure available is for the operational business or commercial property to be held by a company, and in turn, the shares of this company are held by a discretionary trust. This structure personally protects individuals from creditors' claims and ensures the growth in value of the shares is not exposed to estate duty. Moreover, dividends declared by the company are tax free when received by the trust.

As there is no "one-size fits all" solution, Botha suggests taking professional advice before signing any documents. "It can be expensive and complex if a wrong decision is made. It then becomes necessary to unwind the structure and create a new one or transfer property between structures. The appropriate legal structure must be carefully thought out in advance."

This article is extracted from a publication, Tax Breaks, written by Kathy Thersby.

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