



Structuring and Incorporating a Corporate Entity

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The act of incorporation creates a corporate entity with a separate legal structure. That is a corporate entity is seen and treated as being distinct from its owners (shareholders). The advantage is that the corporate entity's debts are not the owners debts, (i.e. shareholder's debts). The liability can therefore in certain circumstances be limited.

What follows is an overview of the advantages and disadvantages of establishing a corporate entity.

The most common business structures today are "sole ownership" and "partnership". Both are relatively easy to establish, administer and exist in businesses that require little start-up capital. There are however, two disadvantages:- Expansion of the business is constrained by the finances the owners can raise. Furthermore the owners face unlimited liability should the business run into debt. The owners' personal assets are, therefore, at risk.

The principal reason for incorporating a corporate entity is for the business to enjoy the advantages of a separate legal structure. That is to say the corporate entity is able to own property, enter into contracts, sue and be sued trade under its own name and be taxed as a separate entity. Once incorporated, the corporate entity exists until

it is wound up - either voluntarily or involuntarily - and therefore has a life that is independent of its owners.

An important consequence is the limited liability enjoyed by the owners. Typically, in a public corporate entity, the owners are the shareholders. Their liability is limited to their shareholding: If the corporate entity is wound up, shareholders' debts will only be limited to the unpaid amount of their shares, or if the shares are fully paid up on issue, they have no further liability. Historically this has proved a major attraction for potential investors. In reality, shareholders of proprietary corporate entities, who may be involved in the managing of the business, are sometimes asked for personal guarantees by banks, which can then extend their liability to personal assets.

Incorporation also allows for the continuity of ownership and the transferability of interest. As the corporate entity's existence is separate from that of, its owners, it survives their death or bankruptcy. Furthermore, if there is a ready market for shares, the shareholders have the ability to sell their interests, thus transferring them to different owners.

In the larger organisation, incorporation usually results in the separation of ownership from control. The owners elect



a board of directors who are charged with the responsibility of running the public corporation. The day to day duties of directors as well as - holding annual general meetings (AGMs) and presenting corporate entity accounts - are defined in the Corporations Act (2001).

There are some further advantages of incorporation that businesses may consider. First, a corporate entity has the right to a unique name and can therefore exploit all the market advantages associated with that name. In contrast, sole traders and partnerships have no such formal protection unless their business names are registered with each state authority. A corporate entity may also be in a position to benefit from access to government grants or borrow capital in it's own right and gain credibility with suppliers. Finally, there may also be taxation advantages that apply uniquely to a corporate entity for both the corporate entity as well as the shareholders.

The drawbacks of forming a corporate entity are the necessary, and often costly, formalities that must be undertaken to ensure that all original shareholders and directors meet all legal requirements (both initially and on an ongoing basis). In addition, corporate entities are required by law to disclose

financial information by way of annual accounts. This may be sufficient cause for some businesses to operate as a trust structure or remain in sole ownership or partnerships.

When considering establishing a corporate entity three principal factors should be considered:

1. Control - who is to control the entity, that is to say who will be the Directors?
2. Assets and liabilities - what will be the assets and what may be the potential liabilities?
3. Benefits - who should be the shareholders and what rights and entitlements to both capital and income should shareholders receive?

The three principles noted above are often referred to as the "CAB Rule". The CAB Rule is a guideline to adopt a simple structured approach in the assessment of any structure.

Summary

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