



The Legal Framework of an Enterprise

Issue 6 - 11 December 2008

Advising a Principal of an Enterprise involves an understanding of the Legal Framework. Regardless of the type of structure (Sole Proprietor, Partnership, Family Discretionary Trust, Unit Trust or Corporate) three factors need to be considered including - who has Control and Management, who has entitlement to Assets and Liabilities and who will Benefit from entitlements to Income, Capital or both Income and Capital. These features can be referred to as the CAB Rule.

Understanding the CAB Rule in relation to any Enterprise will enable the Principal of the Enterprise or their Professional Advisers to understand the legal framework of an Enterprise.

What follows is an overview of the attributes of the Legal Framework of a Business Enterprise.

Control and Management

Control and Management can be separated from benefit recipient.

Implication: The management of an Enterprise should be the primary contact for any one dealing with an Enterprise. However depending on the type of Entity the control of the Entity may differ from

management. For example if the shareholders are different to that of the Directors. Furthermore in any dealings with Principals of Enterprises care needs to be taken to also identify who may have "sufficient influence" over managers or controllers. For example in a Family Business in order to separate and protect assets one spouse may hold personal assets and all trading assets may be held by the other spouse working in the Business. But decision making may be made on a consultative basis. Hence care will need to be taken to determine who in fact is influencing the control of the Enterprise.

Action Required: Carefully consider who in "reality" Controls and Manages the Enterprise.

Assets and Liabilities

Every Enterprise has assets and potential liabilities

Implication: An understanding as to how the Enterprise is structured to utilise and hold assets and account for liabilities is crucial to advising any strategies for Principals of Enterprises. Nevertheless in reality in many instances this basic concept of holding assets and understanding who is responsible for liabilities is not understood by many



Principals let alone their professional advisers.

Action Required: Spend time to understand who or what entity holds the title to the assets and who is responsible for the liabilities of the Enterprise.

Benefit Entitlements

Depending on the nature of the Enterprise the entitlement to income, capital or both may differ in accordance with the needs and objectives of a Principal of an Enterprise.

Implication: Recipients of income, capital or both income and capital may differ drastically between Enterprises and will largely depend on what entity the Principal wishes to direct capital or income derived from the Enterprise. For example rather than holding shares in a corporate entity directly by the Principal, shares are held in a Family Trust. Such a strategy may meet the Principal's need for security and distribution of income on a discretionary basis to different Beneficiaries.

Action Required: Consider carefully who should be the recipient of capital, income or both capital and income and note that the recipients may not be the managers or controllers of the enterprise.

Simplicity

Ease of establishment and operation is a common goal

amongst Principals of any Enterprise.

Implication: The desire to achieve simplicity of the Enterprise with other Principals or benefit holders, needs to be balanced against other needs of Principals including ease of Transfer of Equity, Liability for Debts, Taxation and the ability to raise capital.

Action Required: Balance the need for simplicity against the other principles of Entity Structuring.

Transfer of Equity and/or Benefits

Flexibility in respect to the Transfer of Equity and/or benefits should be considered from the onset.

Implication: As the Enterprise grows and there is a need to raise capital or pass down entitlements to different family members divisibility of the Enterprise becomes an issue.

Action Required: Consider corporates and unit trust entities where there is a strong need for flexibility and transfer of equity and benefits.

Liability for Debts

Liability for the debts of the Enterprise increases exponentially as the Enterprise grows and becomes bigger as does complexity as more Principals become involved. Furthermore depending on the type of



structure such as a Partnership, Principals as Partners may become jointly and severally liable for each others debts irrespective of whether they agreed to the transaction giving rise to the liability.

Implication: Unless management and equity holders are adequately shielded from creditors and other management and entitlement holders they maybe unduly exposed to risk. In such instances corporate and trust entities should be considered over sole proprietorships and partnerships.

Action Required: Liability from creditors and other entitlement holders can be reduced with trust and corporate structures.

Tax

Structuring for tax purposes is one of the main purposes of separate structures.

Implication: Although tax is one of the main reasons for structuring, it should not be the only reason.

Action Required: Consider other implications for structuring an entity as well as tax.

Ability to Raise Capital

The ability to raise capital is fundamental to any successful Enterprise.

Implication: Capital Raising whether via debt or equity adds to complexity due to the conditions normally imposed by Financiers or other third parties. This must be balanced against the need for security against commercial risks.

Action Required: Unless the issues of simplicity are balanced against the need for Capital Raising new structures may need to be put in place.

Conclusion

Unless the legal framework of a Enterprise is easily understood neither the Principals of the Enterprise nor their Advisers can make appropriate recommendations. To find out visit the ili website www.ili.com.au.

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