

CHOOSING THE RIGHT LEGAL STATUS FOR YOUR BUSINESS

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Introduction

When you start a new business you need to make a decision about its legal status and carefully consider some of the issues involved, including the tax implications. This factsheet looks at the main alternatives, including sole trader, partnership or limited company, as well as some of the other, more recent options available, such as a Limited Liability Partnership (LLP) and Community Interest Company (CIC). It highlights the principal differences, advantages and disadvantages of each type of business legal status.

This factsheet will help you to consider the implications of your choice regarding tax, National Insurance (NI), legal liability, raising finance and the accounting records you will have to keep. It also looks at how some of these options fit in with your own personality and the type of business you wish to be associated with.

What are the types of legal status you can choose?

Setting up as a sole trader

A sole trader has complete control over how their business operates, makes all the decisions and takes all the profits. A sole trader can hire employees and give them managerial roles but most sole traders simply wish to run a business on their own. You have the freedom and complete control to run your own business, but you may find the independence limiting when the business begins to grow and you feel the need to share some of the responsibilities.

You can start trading almost immediately, without too much initial investment in overheads. If your business is largely dependent simply on you and your skills, sole trader status could be the most appropriate option. Businesses run by individuals such as consultants, writers or artists, or those in the building trades, often come into this category.

The advantages are:

- The start up formalities are minimal and costs are correspondingly low. You must register as self-employed by contacting HM Revenue & Customs (HMRC). If you think your turnover is going to reach the level that requires compulsory VAT registration in a 12-month period (£68,000 for the period 2009/10) you should also register for VAT immediately. See BIF 234 An Introduction to Value Added Tax (VAT) and visit www.hmrc.gov.uk for details of current VAT registration levels, which usually change in the Budget every year.
- No accounting or business audits are necessary. However, you do need to complete an annual self-assessment form for tax, so you will need to keep accurate records of income and expenses as you pay tax at the personal rate on your net profits.
- Class 4 National Insurance Contributions (NICs) are payable as a percentage of your net profits depending on the levels of profit achieved, as well as fixed-rate Class 2 NICs.
- You have full autonomy over all business decisions, and all earnings from the business belong to you.

The disadvantages are:

- There is unlimited liability for debts, so if the business loses money, you may have to sell your personal assets (house, car and so on) to pay off business debts. In an extreme case this could result in bankruptcy.
- It can be difficult to obtain capital to expand the business as the banks tend to be risk-averse.
- Since the business is dependent on one person, it is unlikely either to survive the death of the sole trader or have much value in itself.
- Growth of the business is likely to be limited as it relies on one person's capacity to work.
- Innovation may be restricted by your isolation from outside influences.
- As a sole trader you are entitled to fewer social security benefits than an employee.

For more information, see BIF 363 A Guide to Setting up a Business as a Sole Trader.

Setting up a partnership

In a partnership, two or more people set up in business together. They share all the risks, costs and responsibilities, as well as the profits.

Each partner needs to register as self-employed. As with a sole trader, fixed-rate Class 2 NICs are payable, as well as Class 4 NICs on each partner's share of the partnership profits.

Although there is no legal requirement to have a written partnership agreement, it is recommended that you consult a solicitor to have one drawn up. The agreement will set out basics such as what share of the profits each partner will take and what their role will be.

Partnerships are often entered into by groups of professionals such as lawyers and accountants, who work together to share skills and knowledge to provide a wider range of services than they could on their own.

The advantages are:

- The business is more likely to survive and continue trading if one of the partners leaves or dies.
- Day-to-day management can be made easier by the allocation of roles to specific partners.
- Greater success might arise through the combination of talents than could be achieved alone.
- More capital may be available to invest in the business.
- Spending time away from the business should be easier as operating responsibilities can be shared.

The disadvantages are:

- Like sole traders, partners have unlimited liability for business debts.
- Disagreements between partners can lead to dissolution of the partnership.
- A partnership relies on the legal concept of 'the utmost good faith': if one partner is dishonest it may cause the others financial difficulty, as all partners are jointly liable for the debt incurred. In Scotland the position is slightly different and one partner can be wholly responsible for the debts of the partnership.
- No legal documents are mandatory so starting off need not be more complicated or expensive than for a sole trader. If you have a partnership agreement professionally drawn up, there will be corresponding legal costs involved.
- The partnership has no legal existence of its own and is simply a collection of individuals. If a partner resigns, dies or goes bankrupt, the partnership can be dissolved.

More information on partnerships is available in BIF 28 A Guide to Setting up a Business as a Partnership.

Setting up a limited company

The biggest difference here is that the business is treated as a separate entity from its owners, with its own legal existence. Most importantly, the company's finances are separate and distinct from the personal finances of the owners.

If you are setting up a venture that needs a lot of start up capital, a limited company will give you more protection if the company fails. It may also be more advantageous to set up as a limited company from a tax point of view, depending on your personal circumstances and expected earning potential.

Shareholders or members of the company can be individuals or other companies. They are not liable for the debts of the company unless they have given personal guarantees on, say, bank loans. If the company is not successful, they may lose the money they have invested but that is the extent of their liability.

The advantages are:

- Liability for debts is limited.
- The organisation is likely to have an unlimited lifespan.
- Capital can be raised by issuing shares.
- Finance comes from shareholders, loans from banks or other financial institutions (which is often easier to obtain than for other business types) and retained profits.
- A board of directors and a management team control the business.
- The overall tax bill might be lower. As a sole trader, all profits are taxed at the personal rate. As a company director, only the salary you pay yourself as an employee of the company is taxed in this way (along with Class 1 NICs), but you may also be able to take 'dividends' out of the company's profits. These are payments that do not attract NI as wages do, although the company will also have to pay employers' NICs. The profits of the company itself are then taxed separately at a lower business rate as corporation tax.
- The business may be perceived as being more 'professional'.

The disadvantages are:

- The costs of administering the business are higher and setting up is more complicated than for other types of business. You

need to have a Memorandum and Articles of Association drawn up, and must register with the Registrar of Companies at Companies House. It is worth noting, however, that companies can be bought 'off the peg' quite cheaply.

- Accounting and audit requirements apply, such as the obligation to file annual accounts at Companies House (see www.companieshouse.gov.uk for more details).

See BIF 167 A Guide to Setting up a Business as a Private Limited Company for further details.

Setting up a Limited Liability Partnership (LLP)

An LLP is really a hybrid of a partnership and a limited company. Unlike an ordinary partnership, each partner's liability is limited to the money they have invested in the business and the amount of personal guarantees they have given to raise finance.

At least two of the partners must be 'designated members', which means they have extra responsibilities. LLPs must register at Companies House and have to file annual returns.

The profits of a member of a LLP remain taxable as a self-employed person and liable to Class 2 and Class 4 NICs.

For further information, see BIF 365 A Guide to Setting up a Business as a Limited Liability Partnership.

Setting up a Community Interest Company (CIC)

CICs are a fairly recent innovation that have only been in existence for a few years. Essentially they are limited companies dedicated to social enterprise. To set up or convert to a CIC, you must register with the CIC Regulator (www.cicregulator.gov.uk) and you will need to:

- Pass a community interest test to show that the business' purpose is socially motivated - for example, providing social housing, employing disadvantaged people or recycling waste.
- Make sure your company Memorandum and Articles (the legal documents setting out the purpose of the company) show that you intend to benefit the community.
- Show that your shareholders approve of the change in status if you are already in business.
- Use your profits and assets for the benefit of the community and not just to benefit you or your employees.

CICs have to comply with all company law on accounting and reporting. The key feature that makes them different is the 'asset lock', which means you can only use CIC assets and profits for activities in the interest of the community.

Reasonable payments can be made to directors and shareholders but if the company goes out of business and is wound up, its assets can only be used for the community.

Potential advantages of setting up a CIC are:

- Access to sources of funding aimed at social enterprises.
- Branding as a social enterprise, which may have marketing advantages.

For further information, see BIF 445 How to Set Up a Community Interest Company.

Can you change the legal status of your business later?

As your business grows, you may decide you need to alter the legal structure so it is more flexible to meet your changing needs. Alternatively, you may find that a partnership, for example, does not suit you.

While it is possible to change the legal status, this may cause problems by disrupting your business, and can be costly and time-consuming.

It is worth thinking very carefully about which business legal status will suit you before you begin. It will be easiest, most practical and cost-effective if you can choose a legal status that suits you and your type of business at start up and for the foreseeable future.

Hints and tips

- If you are setting up a limited company, it is possible to buy existing or 'off-the-shelf' companies via a company registration agent, accountant or solicitor. All the paperwork will have been prepared and the company can begin trading almost immediately.
- Businesses such as franchises, co-operatives and non-profit organisations may be set up as sole traders, partnerships or limited companies.
- Ask a business adviser, accountant or solicitor for advice on which legal status is the most appropriate for your business, and about the tax implications of your choice.

Further information

For practical start up and small business tips, ideas, know-how and news, go to:

Website: www.enterprisequest.com

To access hundreds of practical factsheets, market reports and small business guides, go to:

Website: www.scavenger.net

- BIF 15 An Introduction to Tax, National Insurance and VAT
- BIF 28 A Guide to Setting up a Business as a Partnership
- BIF 66 An Introduction to Setting up a Co-operative Business
- BIF 71 An Introduction to Buying a Franchise
- BIF 167 A Guide to Setting up a Business as a Private Limited Company
- BIF 341 An Introduction to Business Regulations when Starting Up
- BIF 363 A Guide to Setting up a Business as a Sole Trader
- BIF 365 A Guide to Setting up a Business as a Limited Liability Partnership
- BIF 445 How to Set Up a Community Interest Company

Legal publications

'Are you thinking of working for yourself?'

SE1

HM Revenue & Customs (HMRC)

Website: www.hmrc.gov.uk/leaflets/se1.pdf

Useful contacts

HM Revenue & Customs (HMRC)

Tel: 0845 714 3143 (Employers' helpline)

Tel: 0845 607 0143 (Helpline for new employers)

Tel: 0845 915 4515 (Helpline for the newly self-employed)

Website: www.hmrc.gov.uk

Companies House
Crown Way
Maindy
Cardiff
CF14 3UZ
Tel: 030 3123 4500
Website: www.companieshouse.gov.uk

Companies House (Scotland)
4th Floor
Edinburgh Quay 2
139 Fountainbridge
Edinburgh
EH39FF
Tel: 030 3123 4500
Website: www.companieshouse.gov.uk

Companies House (Northern Ireland)
Waterfront Plaza
8 Laganbank Road
Belfast
BT1 3BS
Tel: 030 3123 4500
Website: www.companieshouse.gov.uk

The Community Interest Companies (CIC) Regulator provides information about setting up a CIC.

Room 3.68

Companies House

Crown Way

Maindy

Cardiff

CF14 3UZ

Tel: (029) 2034 6228

Website: www.cicregulator.gov.uk

CONTACT-

for further information.

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