Choosing the Right Legal Status for your Business

Business Information Factsheet
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Introduction

When you start a new business you need to decide which legal status it will have and carefully consider some of the issues involved, including the tax implications. This factsheet outlines the main alternatives, which are sole trader, partnership and limited company. However, there are others available, such as a Limited Liability Partnership (LLP) and Community Interest Company (CIC).

This factsheet highlights the main differences, including the advantages and disadvantages of each type of legal status. It will help you to consider the implications of your choice from the point of view of tax, National Insurance contributions (NICs), legal liability, raising finance and the accounting records you will have to keep.

What are the types of legal status you can choose?

Setting up as a sole trader

If you operate as a sole trader, you have complete control over how your business is run, you make all the decisions and take all the profits. A sole trader can hire employees, but most simply prefer to run a business on their own. Although you have the advantage of freedom and control, you may find the independence limiting if the business begins to grow and you feel the need to share some of the responsibilities.

Operating as a sole trader is often a simpler option than becoming a limited company because there are no registration fees, and preparing accounts and keeping records is more straightforward.

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 (£81,000 for 2014/15) you should also register for VAT immediately. See BIF 234, An Introduction to Value Added Tax (VAT) and go to www.hmrc.gov.uk/vat/start/register/when-to-register.htm 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 and submit an annual self-assessment tax return. You will therefore need to keep accurate records of income and business expenses.

- Class 4 National Insurance Contributions (NICs) are payable as a percentage of your net profits depending on the levels of profit achieved. Fixed-rate Class 2 NICs are also payable.

- You have full autonomy over all business decisions, and all earnings from the business belong to you.

The disadvantages are:

- There is unlimited personal liability for debts, so if your 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 raise finance to expand the business as banks and other funders tend to be risk-averse with regard to lending to sole traders.

- Since your business is dependent on you alone, it is unlikely either to have much value in itself or to survive if you suddenly became unable to work or trade.

- There is very limited capacity for growth of the business because it relies solely on your own capacity to work.

- As a sole trader you are entitled to fewer welfare benefits than an employee.

For more information, see BIF 363, A Guide to Setting up in 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 basic principles such as what share of the profits you and the other partner/s will take and what each partner's 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 in order 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, becomes incapacitated 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 abilities and talents than could be achieved alone.

- More capital may be available to invest in the business.

- You might find it easier to spend time away from the business because operating responsibilities can be shared.

The disadvantages are:

- As with sole traders, partners have unlimited liability for business debts.
- Disagreements between partners can lead to dissolution of the partnership.
- All partners can be held responsible for any one partner's negligence. This is important because individual partners have the freedom to act on behalf of the partnership as a whole, for example to make a binding contract without the authority of the other partners.
- No legal documents are mandatory so starting up need not be more complicated or expensive than for a sole trader. If you have a partnership agreement professionally drawn up, legal costs will be incurred for that purpose.
- The partnership has no legal existence of its own and is simply a collection of individuals. If a partner resigns, dies or goes bankrupt, and there is no partnership agreement, the Partnership Act 1890 will apply, under which the partnership must be dissolved.

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

Setting up a limited company

The biggest difference between limited company status and sole trader or partnership status is that a limited company 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 substantial start-up capital, limited company status will give you more protection if your venture fails. It may also be more beneficial from a tax point of view to set up as a limited company, 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. Therefore, if the company fails, they may lose only the money they have invested in the business.

The advantages are:

- Liability for debts is limited.
- Capital can be raised by issuing shares.
- Finance comes from shareholders, loans from banks or other financial institutions (which are often easier to obtain than for businesses with other types of status) 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 are not subject to NICs as wages are. The profits of the company itself are then taxed separately as corporation tax.
- The business may be perceived as being more 'professional' than one with sole trader status.

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 constitutional documents (called a Memorandum and Articles of Association) drawn up, and the company must be registered with the Registrar of Companies at Companies House. It is worth noting, however, that companies can be bought 'off-the-shelf' quite cheaply via a company registration agent, accountant or solicitor. All the paperwork will have been prepared and the company can begin trading almost immediately.
- Stringent accounting and audit requirements apply, such as the obligation to file annual accounts at Companies House (go to www.companieshouse.gov.uk for details).

See BIF 167, A Guide to Setting up in 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 are required to file annual returns.

If you are a member of an LLP, your share of the profits the partnership makes are taxable as they would be if you were a self-employed person, and liable to Class 2 and Class 4 NICs There are some circumstances where members of LLPs ought to be taxed as employees rather than as self-employed, relating to 'disguised salaries' and how much they contribute to the LLP.

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

Setting up a Community Interest Company (CIC)

A CIC is a legal business status that has only been in existence for a few years. This is essentially a limited company whose primary objectives are social or for community benefit rather than profit making. To set up (or convert your existing business 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 your business' purpose is socially motivated - for example, providing social housing, employing disadvantaged people or recycling waste.
- Ensure 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.

CICs have the same obligation as limited companies to file annual accounts with Companies House. The key feature that makes them different is the 'asset lock'. This means that the assets and profits of a CIC can only be used for activities that will benefit the community. This 'asset lock' will not prevent CICs from using their assets in pursuit of a community benefit, for example they are able to use assets as collateral for raising finance.

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

The advantages are:

- CICs can attract sources of funding that are aimed at social enterprise.
- Trading as a social enterprise may provide marketing advantages.

For further information, see BIF 445, A Guide to Setting 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 particular status does not suit your circumstances.

While it is possible to change the legal status, this may cause problems by disrupting your business and it can be costly and time consuming. For this reason it is advisable to consider very carefully the type of legal status that will suit you before you set up in business.

Hints and tips

- Consider the benefits and drawbacks of the different types of legal status for a business.
- Remember that different types of business, such as franchises, co-operatives and non-profit organisations, can be set up as sole traders, partnerships or limited companies, depending on your personal situation and requirements.
- Ask a business adviser, accountant or solicitor for advice on which legal status is the most appropriate for your business and personal situation, and about the tax implications of your choice.

Further information

For practical start up and small business tips, ideas 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 in Business as a Partnership
BIF 66 A Guide to Setting up a Co-operative Business
BIF 71 An Introduction to Buying a Franchise
BIF 167 A Guide to Setting up in Business as a Private Limited Company
BIF 341 An Introduction to Business Regulations when Starting Up
BIF 363 A Guide to Setting up in Business as a Sole Trader
BIF 365 A Guide to Setting up in Business as a Limited Liability Partnership
BIF 445 A Guide to Setting Up a Community Interest Company

Legal publications

'Thinking of working for yourself?'
HM Revenue & Customs (HMRC)
Website: www.hmrc.gov.uk/leaflets/se1.pdf

Useful contacts

HM Revenue & Customs (HMRC)
Tel: 0300 200 3200 (Employers' helpline)
Tel: 0300 200 3211 (Helpline for new employers)
Tel: 0300 200 3504 (Helpline for the newly self-employed)
Website: www.hmrc.gov.uk

Companies House
Tel: 0303 123 4500
Website: www.companieshouse.gov.uk

The Community Interest Companies (CIC) Regulator provides information about setting up a CIC.
Tel: (029) 2034 6228
Website: www.gov.uk/government/organisations/office-of-the-regulator-of-community-interest-companies

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