Your Business Structure

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Many people assume that everyone who has their own 'business' runs a 'company'. However the two words do not mean the same thing. There are actually four common forms of business structure:

- a sole trader – this is the simplest way of starting and running a business;
- a conventional partnership – where you work with one or more partners in the business;
- a limited liability partnership – LLP – this provides you and your partners with the protection of limited liability, just as with a company; or
- a limited liability company – this means that the business is quite separate to you as a person.

The issue of whether to run your business as a company or a sole trader or partnership is an important decision. And you may change your mind over time. If you want to move your existing business into a company structure this is called 'incorporation'.

When you run your business as a limited company you will have two roles. You will be a shareholder as you will own shares in the company. Shareholders may receive dividends on their shares. You will also be a director who runs the company. Directors are treated as employees even if they don't have employment contracts.

Less tax?

In recent years many people have formed companies (or incorporated their business) in the hope of reducing their overall tax burden. The 'plan' generally involves the company paying the director a low salary and paying Corporation Tax on net profits. The remainder of the company's profits are then distributed by way of dividend payments. With the recent changes in dividend taxation, this benefit is a lot less clear cut.

These days it is rarely a good idea to run your business as a company simply by reference to the tax payable on your annual profits. Additionally, the tax traps awaiting newly incorporated small businesses might well negate the apparent savings. This is even

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more the case when people start trying to reverse the process and disincorporate their companies. All such issues should certainly be considered beforehand so that a reasoned choice of business structure can be made and justified in full knowledge of all the consequences.

Which approach is right for you will depend on a number of factors. These include your cashflow projections, your longer term plans for the business, whether or not you need the protection of limited liability, your willingness to comply with legal and administrative obligations and the nature of any investment you are seeking.

Headline differences

Sole trader

The advantages of being a sole trader include independence, ease of set up and running your business, and the fact that all the profits go to you.

The disadvantages include a lack of support, unlimited liability, the prospect of paying more tax on high profits and the fact that you are personally responsible for any debts run up by your business.

Partnership

The advantages of being in a partnership include its ease of set up and running, and the range of skills and experience that the partners can bring to the business.

On the other hand, problems can occur when there are disagreements between partners. There is unlimited liability and all partners are each personally responsible for all of the debts that the business runs up. Again there is the prospect of paying more tax on high profits than if you have a company.

Limited Liability Partnership (LLP)

LLPs retain the flexibility of a partnership with the added advantage that your personal liability is limited. At least two members must be 'designated members' - the law places extra responsibilities on them.

The formation of an LLP is more complex and costly than that of a conventional partnership. Problems can still arise when there are disagreements between the members. Again there is the prospect of paying more tax on high profits than if you have a company.

Limited Liability Company

If you run your business through a company your personal financial risk will be restricted to how much you invest in the business and any guarantees you have given in order to obtain financing. You will also be able to retain more money in the company after paying less tax than if you operate as a sole trader or partnership.

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However, you should remember that this type of business structure, more than any other, also brings a range of extra legal duties, including the maintenance of the company's public records, e.g. for the purpose of the filing of accounts.

Franchise

The major advantage of a franchise is that it takes advantage of the success of an established business and support networks. Even if you become a franchisee you may still be allowed to choose whether or not to operate as a limited company.

However, as a franchisee your freedom to manage the business will be constrained by the terms of the franchise agreement. Also franchisees often pay a share of their turnover to the franchiser, which reduces overall profits.

Social enterprises

Social enterprises are businesses that trade for a social purpose and represent a diverse and growing range of business activity across the UK.

Incorporation issues

Capital gains

Incorporating an existing business will involve a transfer of goodwill – and possibly other assets too. This transfer can create significant capital gains which may be subject to tax. However, there are mechanisms for deferring these gains until any later sale of the company. We will need to discuss in detail with you the most appropriate mechanism for your business.

Income tax

Special rules apply when a business is transferred to a limited company. The old business is treated as ceasing for tax purposes. You may want to time this to your best advantage. The precise effects and choices will depend on how long you have been trading, whether your profits have been increasing and on your projections for the future.

Capital allowances

Once again the position needs to be carefully considered.

Stamp Duty Land Tax (SDLT)

If your business has any property interests there may be SDLT charges to consider when these are transferred to a company.

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Other Advantages

There may be other non-tax advantages of incorporation and these are summarised below.

Limited liability

A company normally provides you with limited liability. If a shareholder's shares are fully paid he cannot normally be required to invest any more in the company.

However, banks, franchisors and landlords often require personal guarantees from the directors for borrowings. The advantage of limited liability will generally apply in respect of liabilities to other creditors.

Pension provision

The company could establish an approved pension scheme which may provide greater benefits than self-employed schemes.

Legal continuity

A company (and an LLP) will enjoy legal continuity as it is a legal entity in its own right, separate from its owners (the shareholders). It can own property, sue and be sued. A company will also continue to exist even if you die.

Transfer of ownership

You can sell the shares in your company more easily than you can sell your interest in a partnership or LLP. When the time comes to sell however, the purchaser may prefer to buy the business from the company rather than buy your shares.

You can also transfer ownership of your shares to family members, friends and employees. There will be tax consequences of doing this so it is best to take advice beforehand.

Borrowing

Normally a bank is able to take extra security by means of a 'floating charge' over the assets of a company or an LLP. This will increase the extent to which monies may be borrowed against the assets of the business.

Credibility

The existence of a company is sometimes deemed to add to the credibility or commercial respectability of the business.

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Staff incentives

Employees may, with adequate safeguards, be offered an opportunity to acquire an interest in the business, reflecting their position in the company.

Disadvantages

In addition to the prospect of more tax being payable on company profits, in some cases, there are also other disadvantages to consider:

Administration

The annual compliance requirements for a company in terms of administration and accounting tend to result in higher running costs than for a sole trader or partnership. Annual accounts need to be prepared in a format dictated by the Companies Act and, in some cases, the accounts need to be audited by a registered auditor. This is typically only where you operate in certain fields or if two if the following apply

— the company turnover (sales) is above £6.5m net
— its assets (eg: property) are worth more than £3.26 million net and
— the company has 50 or more employees on average.

PAYE/Benefits

If you do not have any employees at present, you do not have to be concerned with PAYE and returns of benefits forms (P11Ds). Once you have a company and become a director you will be considered to be an employee. The company will need to complete PAYE records for salary payments and keep records of expenses reimbursed to you. Forms P11D may also have to be completed each year.

Transactions with the business owner

A business owner may introduce funds to and withdraw funds from an unincorporated business without tax implications. When a company is involved there are often tax implications on these transactions. Then company's money is not your money until after it has been paid out to you by the company.

Director's responsibilities

A company director may be at risk of criminal or civil penalty proceedings e.g. for late filing of accounts or for breaking the insolvency rules.

Lack of Privacy

The annual accounts of companies and LLPs have to be made available on public record - although these can be modified to minimise the information disclosed. Details of the directors and shareholders are also filed on the public register held by the Registrar of Companies.

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Extraction of funds

If you operate your business through a limited company structure you will want to consider the most tax effective methods of withdrawing funds. The options include: salary, bonus, benefits in kind, loans, dividends and, in some cases, repayment of monies you have loaned to the company. Each has different tax consequences and there are also certain legal obligations to ensure that the taxman agrees the nature of the transaction for tax purposes.

How we can help

The choice of business structure is an important one, both at the outset and also if you are considering incorporation at a later date.

We would welcome the opportunity to talk to you about your specific circumstances. We can help you to consider all the relevant factors and choose the appropriate business structure. If incorporation is relevant we can guide you through the process and relieve you of many of the administrative burdens.

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