BUSINESS

SOLE TRADER, LIMITED COMPANY OR PARTNERSHIP?

HOW TO DETERMINE YOUR BEST BUSINESS STRUCTURE

Interface

Independent Financial Advisers - Financial Life Planners

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Introduction

A key decision for all business owners, especially when starting a business, or becoming self-employed for the first time, is to decide what type of business structure to use.

There are several options which essentially fall into four key alternatives:

- Sole trader
- Partnership
- Limited liability partnership (LLP)
- Limited company

Other options may exists for social enterprises that are looking to benefit the community; but these are not covered in this guide.

UNDER THE SOLE TRADER STATUS, YOU AND YOUR BUSINESS ARE EFFECTIVELY ONE AND THE SAME... YOU CAN EVEN EMPLOY OTHER PEOPLE

Sole Trader

The sole trader or self-employed route is the easiest structure to use.

Under the sole trader status, you and your business are effectively one and the same – from both a tax and legal perspective and you are personally responsible for the business. This includes any and all of your business debts.

The profits you make until the 5th April of each year are declared on your tax return and classed as your personal income that year.

You must pay income tax and national insurance on this at standard income tax rates. You do not need to register the business anywhere, but you should tell HMRC that you are in operation and self-employed for tax purposes. You must do this within three months of becoming self-employed.

National Insurance contributions are usually lower as a sole trader. However, you will be entitled to fewer social security benefits.

The administrative burden is far lower than the alternatives. You keep simple, unaudited accounts which list and record your business income and expenditure.

You can form a limited company – or partnership – later down the line and transfer the business to it (though in some circumstances stamp duty may have to be paid).

Sole traders can employ people.

Partnerships

A partnership arrangement is similar to that of a sole trader but differs in that it is a business owned by two or more people. All partners own a specified percentage of the profits paying tax on that percentage.

As with a sole trader, each partner's share of the profits is treated as their income.

Partners, like sole traders, are generally considered and taxed as self-employed.

As a member of a partnership you will be personally or jointly liable for any debts incurred. This means that if another partner is unable to pay, you become liable for their share of any business debts.

National Insurance contributions are usually lower as a member of a partnership than as an employee of a limited company. However, you will be entitled to fewer social security benefits.

You may be able to raise money for your business by introducing new partners.

Business contracts entered into by one partner can be binding even if the other partners have not consented.

As a partnership the risks of the business and the management responsibilities, decisions etc. will be shared. This will almost always mean it is sensible and prudent to draw up a comprehensive partnership agreement — this will help avoid disputes. On a positive note it will enable partners to stipulate who does what and the dividing lines when it comes to day to day functions and activities.

It's a good idea to get a solicitor or professional adviser to draw up a suitable agreement.

A good, comprehensive partnership agreement should cover and include the following (as examples):

- The names of the partners, the name of the business and what the business does.
- State the date the partnership starts and how long it will last if it isn't a permanent arrangement.
- Set out how much capital each partner will contribute.
- State how profits and losses will be shared and how much money each partner can draw from the business.
- Clarify how the business will be run. For example, how much time each partner is to put into the business, how much each partner will invest, what their responsibilities will be and how fast you want the business to grow.
- Set out details of holiday entitlements.
- Explain what will happen if partners die, become ill, want to retire or reduce their involvement. Set out what the arrangements will be for introducing new partners.

This bullet point list is illustrative, you should get professional help in drawing up a suitable agreement.

Limited Liability Partnerships (LLPs)

LLPs, as they are commonly known, have some aspects of the partnership structure but also some characteristics of a limited company. In this sense, they can be described as a hybrid between the two.

An LLP is a way of forming a partnership while limiting your personal liability for business debts.

An LLP has the organisational flexibility of a partnership. Members share management responsibilities and you may be able to introduce new members to raise money.

Each member's liability is limited to any personal guarantees they have made to secure finance and any money they have personally invested.

Any withdrawals of capital from the business can be clawed back if the partnership is declared insolvent - within two years of the withdrawal.

Bear in mind that forming an LLP is more expensive and complicated than setting up a partnership. For example, as with a limited company, you must register a LLP with Companies House and file annual accounts. You must also submit a Confirmation Statement giving details of the LLP and its members.

AN LLP IS A WAY OF FORMING A PARTNERSHIP WHILE LIMITING YOUR PERSONAL LIABILITY FOR BUSINESS DEBTS

Members of an LLP are generally taxed as self-employed. Income tax will be payable on each partner's share of any profits, whether or not they are distributed to members.

National Insurance contributions are usually lower as a member of an LLP than as an employee of a limited company. However, you will be entitled to fewer social security benefits.

Self-employed members of an LLP must register as self-employed with HM Revenue & Customs within three months of starting up.

It is very important to draw up a partnership agreement if you are setting up an LLP. See section above on partnerships to get an idea of what should be covered in this agreement. The partnership agreement is confidential to members.

It is sensible to seek professional help in preparing an LLP agreement.

Limited Companies

With a limited company, the business becomes a separate legal entity in its own right. This means that the company must be formed, or incorporated, and registered at Companies House.

The company will also need certain standard documents; for example, a memorandum of association and articles of association. These set out who is forming the company and how it will be run: for example, how decisions will be made and how shares will be dealt with. The memorandum and articles must be sent to and registered at Companies House.

You must have at least one director of the company. You are not required to appoint a company secretary, but you may do so if you wish. One director could cover both roles.

The company will be owned and controlled by those who own its shares and you can allocate shares to any number of people when the company is incorporated.

Annual Accounts and a Confirmation Statement need to be filed at Companies House. Your company must pay corporation tax on its profits and you will be taxed as an employee. Company directors pay income tax on salaries and benefits through PAYE like other employees.

National Insurance payments are higher than for a sole trader or partnership. You have to pay employer's as well as employees' National Insurance contributions on salaries (including those of directors).

Starting out

The structure of your business - if you are about to start out- is not as important as ensuring you have a well prepared business plan.

Even if you start on day one as a sole trader, you can change quite easily and quickly to a different status further down the line (see section below).

Many start-ups fail in their early years because of cash flow problems or not establishing their market presence or because the management make mistakes. There are multiple reasons why businesses fall down but the risk of failure is most pronounced in the early years. Business planning from day one is crucial.

You should focus on getting your business plan as good as you can possibly get it. This must be the priority. Part of your plan can be the method by which you will run your business and this can include how you will be structured. Deciding on the right structure from day one can be determined by weighing up the key considerations for your business as outlined in the section "The key considerations".

Already in business? Changing your structure

Once you are in business and up and running, then you are free to change your structure at any time. Often this may be down to finances, if your business starts to make sizable profits, you may decide that you will be able to pay less tax, via incorporation.

Or you may have developed and taken on new employees and wish to offer them shares in your business; likewise you may decide you want to expand and take on a new partner.

The pros and cons of using a particular structure are often different or more pronounced at different stages of development or depending on how much money you are making; or your strategic direction may have changed.

You are never stuck with your existing structure, you can change it to suit your circumstances as they evolve or change. However be wary that changing structure could involve expense or trigger a tax charge depending on circumstances.

The key considerations:

1. Risks and Rewards

As stated the 'drivers' which influence your decision will vary depending on your industry or sector, stage, size, profits, amongst others. For example, many people will want to reduce their exposure (risk) to losses or debt, therefore the limited company route may be more appropriate as it allows for some form of limited liability.

However for many traders, acting as a sole trader may be less expensive and reduces hassle or unnecessary complications. It keeps things relatively simple.

The LLP route may be best for professional partnerships as the partners can remain self-employed for tax purposes but reduce (limit) their risk in the context of the partnerships overall responsibilities.

An individual running a successful small business who has family members may decide to incorporate as they can involve their spouse and children in the business structure, for example by awarding them shares in the company.

In deciding on what structure to use you should start by identifying what the risks and rewards are which apply to your circumstances.

2. Paperwork, responsibilities and costs

Different options present totally different requirements with respect to the records you need to keep, the forms you need to file and the extent of the reporting obligations. If your business is relatively straightforward, it would be fair to think that your costs would be less if you act on a self-employed basis.

Company directors have far more responsibility (and by implication, downside risk) in managing a company and if those responsibilities are not met, serious sanctions may apply.

3. Tax

Different structures can have highly different tax outcomes for the individual owner or owners. Tax is normally a major contributor to the decision as to which structure to use. This is not just about income tax vs corporation tax; there could be national insurance considerations and/or thoughts about selling your business (future capital gains tax?) amongst others.

However, on its own, tax should not dictate the structure at the exclusion of all other considerations.

4. Legal

If you are in business on your own then your legal considerations may be fairly few, you may still want to think about your supplier relationships, for example, and how your structure impacts on these but otherwise legal concerns will probably be greatest for those who go into business with others.

It is worth noting that many litigants in business cases were one time friends or business partners/colleagues.

Things can go wrong and often do, people who set out together on a common mission sometimes fall out. So your business structure needs to cater for all future scenarios and legally you should tie down as many aspects as you can.

It is always wise to have a well-constructed partner agreement in a partnership arrangement, and with a limited company where there are multiple shareholders – a shareholders agreement.

In many businesses such things as Intellectual Property may be significant.

In others there may be a disparity between the working hours, money, skills or other efforts put in by different parties. Any or each of these factors may help dictate a different structure depending on circumstances.

5. Employing others

As a business owner you may well employ people. In most respects your employer obligations and responsibilities will not change if you change structure. Employment law does not allow for any mitigation of responsibility based on your structure.

However if you want to reward employees with a stake in the business and provide some form of share incentive, you would need to be formed as a company.

6. Fund Raising

It may be easier to raise funds under one structure than another. Lenders will always be seeking maximum security for any loans, this can make them wary of lending to a limited company, unless they can take personal guarantees. Your possessions — including your home — can be at risk if you fail to pay your debts, or if you give a personal guarantee.

You may want to lend money to your own business and there may be ways to do this which are easier or more tax efficient, depending on the structure you use.

You could decide that you want to obtain extra funding by issuing shares to an outside shareholder or by forming a partnership and taking on new partners who 'buy' into the partnership.

YOUR POSSESSIONS INCLUDING YOUR HOME CAN BE AT RISK IF YOU FAIL TO PAY YOUR DEBTS, OR IF YOU GIVE A PERSONAL GUARANTEE

7. Perception

The way your business is perceived could be important to customers, lenders, investors, the media or suppliers; you may want to create a perception of your business with a certain targeted audience. Marketing your business in a certain way could affect sales or new enquiries and the name and status you imply could be relevant. Likewise certain commercial arrangements may be more easily achieved (see below).

Acting as a company or as a Limited Liability Partnership (LLP) means your accounts will be publicly viewable, which could be a factor.

8. Supplier Requirements

You may be contractually obliged to operate as a certain type of entity with certain trade or business contacts; many supplier requirements stipulate certain conditions of this type.

As an example you could be aiming to supply a product into a supermarket. The supermarket may have terms which state they will not deal with sole traders and/or only with registered companies.

IDENTIFYING THE BEST OPTION FOR YOU IS A DECISION WHICH REQUIRES BALANCING THE LEVELS OF PERSONAL LIABILITY, TAX POSITION, ADMINISTRATION AND PERCEPTION

Taking advice and getting help

The key considerations listed above are not necessarily the totality of all the relevant factors.

They are provided to illustrate the range and type of factor you will need to bring into your thinking.

Identifying the best option for you is a decision which requires balancing all these aspects against each other. These include the level of personal liability you are willing to take for business debts, your personal tax position, the level of administration you want to do and how you want your business to be perceived.

It is also a decision which may need to be reviewed from time to time.

We are here to help you and can provide you with advice and help. The advice you need will probably be a mix of financial advice, tax and accountancy advice, possibly some legal advice. It is sensible to work with specialists in each area.

Finally, it is very unlikely your business requirements, including how you structure your business, will be separate from your personal finances. There will be considerable overlap, therefore taking an integrated approach and working with advisers who can help you span both the business and personal is likely to be a sensible step.

History, structure, and expertise

Interface Financial Planning started providing independent financial advice in 1992. From the beginning it had the aim of providing professional advice and quality service to people with modest income and wealth.

Its key value was putting people before profit, and contribution before reward. This mission statement has been our torch to light the path ahead and has been the reason that we have endured for over 24 years.

Alan has lead the company with his personal values of: Integrity, Compassion, Respect, & Loyalty, and he is proud that over the years he has worked with clients who share similar values. Like him they want to help others and make the world a little better.

Client care and service is important and he is proud that his first two clients from January 1990 remain his clients today.

We believe that every client should have access to highly qualified advice and expertise.

Technology is used to the full to maximise efficiency and engage expertise from throughout the UK. The business has been paperless for 10 years and for over 5 years has been 'cloud' based. This structure reduces costs and allows support staff to operate anywhere - from Colchester to Honiton to Leicester and elsewhere.

Clients are encouraged to access their online account where they can exchange messages and documents securely. They can view their investments and reports, and they have immediate access to their paper file. Clients love the transparency and openness of being able to view and print paperwork going back for years and many clients use it as a source of reference.

ALAN MORAN
Owner, Director
Interface Financial Planning

Alan Moran is one of the most highly qualified advisers in the UK. He became a Certified Financial Planner in 1995 and he was one of the first Chartered Financial Planners in 2005.

He is a Chartered FCSI, a holder of the IMC certificate and member of CFA UK. His expertise has been called upon by The CII, The IFP, The Kinder Institute, and others, where he has trained and examined other financial advisers.

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