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Chartered Certified Accountants

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Starting Up: Forming a Business

Introduction

When a business starts up there are a number of different legal structures under which it can operate. Each of these ways has their own implications and their suitability revolves around a number of different factors:

- The nature and size of the business
- The way the business can raise finance
- The way decisions are made in the business
- Your personal liability if the business fails
- The records that need to be kept
- The amount of tax that you or the business will have to pay

There isn't a universal answer to what is the best form of legal or tax structure to use and there are advantages and disadvantages with each option. This Fact Sheet will help you along the way towards making an informed choice. As always with a decision as important as this for your business, you should take professional advice from a qualified accountant before making a commitment.

Sole trader

A sole trader is a type of business entity that legally has no separate existence from its owner. The law makes no distinction between the business and the sole trader - they are one and the same.
If you set-up as a sole trader, you should inform HM Revenue & Customs (HMRC) within 3 months of starting out. There is a HMRC form you should use with a reference CWF1. At this point you will also need to start paying Class 2 National Insurance Contributions (NICs). These are relatively small (around £10/month for 2009/10) and it's advisable to set up a direct debit for them.

Advantages

- As a sole trader you will only need to prepare basic accounts and a self assessment tax return. Consequently the accountancy fees tend to be lower for a sole trader as there is reduced administrative burden.

- Many businesses are initially loss making. If you leave a job to become self-employed, and make a loss, you can offset that loss against your previous employment income. If you have other income such as savings interest, dividends, or rental income, then again, the sole trader losses can be set-off against these. This can result in a repayment of tax in the early period of trading. With a limited company, losses cannot be offset against your personal income.

- As a sole trader, you only need to submit information to HMRC and your sales income, profits and tax affairs are private between you, your accountant and HMRC. Limited companies must file accounts with Companies House which are in the public domain for anyone to see.

Disadvantages

- Because there is no legal separation between the individual and the business, a sole trader is liable for all the business debts and this can put at risk not only assets used in the business but also personal assets too.

- A sole trader business usually ceases on the owner's retirement or death.

- Your entitlement to state benefits as a sole trader can be reduced.

- Options for raising finance are more restricted for a sole trader. For example pledging business debts separately from other personal asset to provide security to a lender is difficult.

- If you really are working on your own it can be hard not having a business partner to share responsibilities.

National Minimum Wage

The national minimum wage (NMW) does not apply to the genuinely self-employed.

In the case of a sole trader because there is no distinction between the individual and the business and no contract of employment, the national minimum wage does not apply to sole traders themselves. Clearly if the business was not profitable it would be illogical to force the sole trader to pay him or herself a salary they could not afford.

Company directors are classed as 'office holders' in common law and can do work and be paid for it in that capacity without necessarily having an employment contract. In the case of a small company perhaps with a single director or a husband and wife as directors, employment contracts are unlikely and there is no obligation to pay or entitlement to pay the NMW.

Company directors who have employment contracts will need to be paid the NMW. If a company director is unsure whether he has entered into an employment contract with his company he may wish to take legal advice.'

In the case of unincorporated family businesses, members of the family who still live at home and work in the business are exempt from the NMW, as are non-relatives that live and work within the home. However, if the business operates as a company this exemption does not apply, and all employees of the company must receive the NMW appropriate to their age.

Partnership

There are two main legal forms of partnership:

- Ordinary partnerships
- Limited Liability partnership (LLP)

There is also a separate legal from called a limited partnership but this is infrequently used now that the LLP option is available.

Ordinary Partnerships

An ordinary or general partnership is an extension of being a sole trader. In a partnership a group of two or more people will come together in business and pool their resources. The aim is that, collectively they can build a more successful business than they would individually. The partners will agree to share the joint profits in pre-determined percentages. It is advisable to take legal advice and draw up a Partnership Agreement which sets out the rules on how the partners will work together. The agreement will typically deal with partners' responsibilities, salaries, profit sharing, the amount of capital each partner puts in and voting rights for example.
Partners are taxed in the same way as sole traders, but only on their own share of the partnership profits.

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Advantages

- Partners will bring to the business different skills, knowledge and experience.
- Partners can provide mutual support and improved decision-making through discussion and agreement on how the business is run.
- New partners can be taken on to raise finance, provide specialist skills or introduce new business.

Disadvantages

- There is no restriction on your exposure to business creditors as a partner. Each partner is 'jointly and severally' liable for the partnership debts, so that if certain partners are unable to pay their share of the partnership debts then responsibility for those debts can fall on the other partners.
- Decision-making can take longer as consensus between the partners must be reached.
- Different partners may have different aims and amitions for the business and this might potentially be a source of disagreement.

Limited Liability Partnership

A limited liability partnership is legally similar to a company in that it is a body corporate with separate legal personality, and the liability of its 'members' is limited. It is administered like a company in all aspects except its taxation. For tax purposes it is treated like a ordinary partnership. Members of an LLP have the protection of limited liability and the administrative and statutory obligations of a company but not the taxation and national insurance flexibility. LLPs are particularly suitable for medium and large-sized partnerships. An LLP can be formed by at least two people and as with an ordinary partnership it is advisable to have a suitable members' agreement drawn up by a lawyer.

Advantages

- A limited liability partnership is legally similar to a company in that it a body corporate with its own legal identity and capacity.
- Members of an LLP can limit their personal liability for business debts.
- An LLP provides the same organisational flexibility of a partnership to introduce new partners or change the ownership structure between the partners.
- The members' agreement is confidential.

Disadvantages

- Annual accounts must be prepared and filed and there are other filing requirements with strict time limits for compliance.
- Each member is subject to income tax on his/her own income from the firm as if they were self-employed.
- On winding up an LLP as a result of insolvency, there are special clawback provisions applied to members. These provisions apply only to LLPs and not to companies.

Limited Company

Where as sole traders and partners can be held personally liable for all business debts, a limited company is a legal entity separate to its directors and shareholders. As a separate corporate body a company can own property, incur debts, sue and be sued in its own right. Any business dealings are made on behalf of the company so the owners are normally liable only for the amount invested as shareholders. There must be at least one director to manage the business. Since 6 April 2008 a private company does not have to have a company secretary.

There are several methods of setting up or 'incorporating' a company:

- Dealing directly with the Registrar of Companies (www.companieshouse.gov.uk)
- Using an accountant or solicitor - forming a company brings with it obligations for the directors and you should take professional advice on whether it is the right choice for your business.
- Using a company formation service or on-line registration agent.

Advantages

- Limited liability status provides some protection for you as a director if the business is not successful. In simple terms if a company cannot afford to pay all its debts the directors will not normally be personally liable for them. There are strict rules regarding wrongful and fraudulent trading and directors can be held personally liable if they have acted negligently or fraudulently. Often though a new company may not be able to get substantial trade credit from suppliers or bank finance without a director's personal guarantee (a 'PG').
- Shares in a company can be created and transferred to divide the ownership subject to company law and the company's constitution contained in a document called the Articles of Association. Careful consideration must always be given to the tax consequences of any share transfers.
- A company as a separate legal entity survives the retirement or death of its owners.
- A limited company can be perceived has having more credibility making it easier to raise finance. Financing options such as debentures and invoice discounting are available to companies which are not available to sole traders.
- A company can pay dividends to shareholders which can be a advantageous in reducing the overall tax payable compared with income paid as salary which is subject to tax and both employee's and employers National Insurance (NI).
- Limited companies are taxed on their profits at corporation tax rates (typically lower than personal income tax rates. If, therefore, you have a profitable business but do not need to withdraw all the profits, then a limited company may provides some tax advantages.
- Some business customers may feel more comfortable trading with a limited company rather than a sole trader. They may have a perception that a limited company will be a more established business, and therefore more reliable. The reality of course that creditability is more to do with how you market and present your business and ultimately how effective you are at meeting the needs of your customers.

Disadvantages

- Annual accounts are more complicated to prepare and specific details and disclosures need to be filed with the Registrar of Companies. This usually makes it necessary to use a qualified accountant to prepare accounts for the company.
- Financial information about the business will be in the public domain for anyone who is interested to see.
- Directors are treated as employees for any salary that they draw and so are subject to income tax and NI on their salary from the company. In addition, the company must also pay employer's NI on the directors' salaries.
- Shareholders and directors may have to personally guarantee contracts entered into with lenders or suppliers so personal liability can still arise.
- The tax position arising on the incorporation of an existing business needs careful analysis. It may be possible to defer capitals gains tax (CGT) on the transfer of assets but the timing and effect of cessation must be carefully planned.
- A statutory audit is required if a company has turnover in excess of £6.5m and a balance sheet total of £3.26m. This can increase the administrative burden and accountancy costs.
- It can be more difficult and expensive to close or wind-up a company compared to a sole trader or partnership business.
- A company director is more at risk of civil or criminal proceedings or penalties which can arise for late filing of accounts or from breaches of insolvency rules such as those relating to wrongful of fraudulent trading.

Other Legal Requirements to Consider

- Depending on your trade or sector, you may need some form of statutory licence to run your business.
- You must have adequate insurance for the business. If you have employees, you must have employers' liability insurance. Get advice from an insurance professional.
- Notify HMRC when you begin trading and use an accountant to help you keep your tax, NI and VAT affairs in order.
- You must ensure your premises comply with property regulations. If your business is based at home, you need to consider whether your title deeds, mortgage or tenancy agreement places any restrictions on this.
- You may need to consider if planning permission is needed or if the business will generate traffic or disturb neighbours.
- If part of your home is treated as non-residential, there may be tax implications.
- All businesses have to comply with health and safety and environments regulations even if they are home-based.

The Self-employed and the State Second Pension

It's worth taking a detour for a moment to mention the State Second Pension. The State Second Pension or S2P is a top-up pension to the Basic State Pension, based on the average salary you earn during your working life. S2P is compulsory for all employees, except for those workers who decide to 'contract out'. If you contract out the government pays you a rebate each year. This rebate has to be invested with a pension or insurance company (or into a company pension scheme), and the intention is that it will eventually produce a similar pension income comparable with what S2P would provide. Of course the value of your investments could go down and that might mean your pension income is lower than it would have been under S2P.

The level of benefit for S2P is depends on how much you earn and how much Class 1 National Insurance Contributions you pay. Sole traders do not pay this type of National Insurance (the self-employed pay Class 2 and Class 4 NI) and, therefore are not entitled to S2P. Employment status can also affect entitlement to other state benefits such as tax credits.

How Harrington Kelly can help

If you are at all unsure as to which legal structure is right for you, we can advise you based on your specific circumstances. Making the wrong decision can be costly. Our initial meeting is free and we can help you make an informed choice.
As a client we can help you with your accounting and tax whether you are a sole trader, a partnership or a limited company. We can effectively run your finance function for you as part of our outsourced accounting solution or help you at various stages in the accounting year and at year-end for statutory accounts and tax.

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The Tax Position: Sole Trader v Limited Company

For many people starting up in business, minimising tax will be one of the key drivers in deciding what type of legal structure to adopt.
The example below shows the potential advantages of using dividends compared with salary to extract profits of £15,000, £30,000, £60,000 or £100,000 as a sole trader compared with a company.

	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Note
Sole Trader	£	£	£	£	
Sole Drawer Salary/Drawings	15,000	30,000	60,000	100,000	
Less Personal Allowance	-6,475	-6,475	-6,475	-6,475	
Taxable pay	8,525	23,525	53,525	93,525	
Income Tax Payable					
20%	-1,705	-4,705	-7,480	-7,480	
40%			-6,450	-22,450	
National Insurance					
Class 2	-125	-125	-125	-125	1
Class 4	-743	-1,943	-3,214	-3,614	2
Total Tax & NI Payable	-2,573	-6,773	-17,269	-33,669	

	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Note
Limited Company					
Trading Profits before salary or dividends	15,000	30,000	60,000	100,000	
Salary	-5715	-5715	-5715	-5715	3
Profit Subject to Corporation Tax	9,285	24,285	54,285	94,285	
Corporation Tax					
21%	-1,950	-5,100	-11,400	-19,800	
Profit after tax (available for dividend)	7,335	19,185	42,885	74,485	4
Dividend	7,335	19,185	42,885	74,485	
Income Tax on Dividend					
32.5% (for a higher rate tax payer)			-2,135	-10,036	5
Total Tax Payable	-1,950	-5,100	-13,535	-29,836	
Potential Tax Saving	-623	-1,673	-3,734	-3,833	

1. Class 2 Ni is payable at £2.40 per week for 2009/10
2. Class 4 NI is payable at 8% above on profits between £5,715 and £43,875 and 1% above this level for 2009/10
3. Salary at this level £5,715 will ensure entitlement to benefits such as State Pension
4. This is amount of dividend the company could pay to a director/shareholder
5. For a basic rate tax payer there is no additional tax liability on the dividend. For a higher rate tax payer the dividend is subject to further tax. Below is the calulation for the £60,000 profit scenario.

			£
Net Dividend			42,885
Gross Dividend (Gross up by 100/90)			47,650
Salary			5,715
Total Income			53,365
Less Personal Allowance			6,475
Taxable Income			46,890
Tax at 20%	37,400		No additional liability
Tax at 32.5%	9,490		3,084
Less dividend tax credit		10%	-949
Additional tax liability	46,890		2,135

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