Selecting a Legal Entity for Your Business

One of the first major decisions you will have to make as you start your new business is the form of legal entity it will take. To a large degree, this decision may be dictated by the way you have organised your operations and whether you intend to work on your own or in conjunction with others.

The form of entity you choose can have a significant impact on the way you are protected under the law and the way you are affected by taxation rules and regulations. There are four basic forms of business organisation. Each has its own benefits and drawbacks and is treated differently for legal and tax purposes.

Sole Proprietorship

A sole proprietorship is typically a business owned and operated by one individual. A sole proprietorship is not considered to be a separate legal entity under the law, but rather is an extension of the individual who owns it.

The owner has possession of the business assets and is directly responsible for the debts and other liabilities incurred by the business. The profit or loss of a sole proprietorship is combined with the other income of an individual for income tax purposes.

A sole proprietorship is perhaps the easiest form of business to own and operate because it does not require any specific legal organisation, except, of course, the normal requirements such as licenses or permits.

A sole proprietorship typically does not have any rules or operating regulations under which it must function. The business decisions are solely the result of the owner's abilities.

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Partnership

In a partnership, two or more individuals join together to run the business enterprise. Each of the individual partners has ownership of partnership assets and responsibility for liabilities, as well as authority in running the business.

The authority of the partners, and the way in which profits or losses are to be shared, can be modified by the partnership agreement.

The responsibility for liabilities can also be modified by agreement among the partners, but partnership creditors typically have recourse to the personal assets of all of the partners for settlement of partnership debts.

The rights, responsibilities and obligations of partners are typically detailed in a partnership agreement. It is a good idea to have such an agreement for any partnership.

A partnership is a legal entity recognised under the law and, as such, it has rights and responsibilities in and of itself. A partnership can sign contracts, obtain trade credit and borrow money. When a partnership is small, most creditors require a personal guarantee of the general partners for credit.

A partnership is also required to file an income tax return. A partnership typically does not pay income tax; the information from the partnership tax return is combined with the personal income of the partners to determine their overall tax liability.

Limited Liability Partnership

The Limited Liability Partnership ("LLP") offers limited liability to its members but, like a traditional partnership, is tax transparent and offers flexibility in terms of its internal organisation.

An LLP is a separate legal entity from its members. Therefore, it may enter into contracts and deeds, sue and be sued and grant floating charges over its assets in its own name.

This avoids the problems that exist in relation to partnerships, where technically it is often necessary for every partner to be party to certain documents or litigation, and the creation of floating charges is not possible.

The members of the LLP are those persons registered at Companies House as members. These members can be individuals, limited companies or even another LLP.

The main "price" paid in return for limited liability is public availability of financial statements. An LLP must file accounts (prepared on a "true and fair view" basis) annually at Companies House, the same as a limited company.

In addition, the LLP must also file details of the name and address of every member at Companies House. At least two members must be "designated members" responsible for making proper filings at Companies House (and subject to penalties in the event of default).

Provided an LLP carries on a trade or a profession and is not simply an investment vehicle, it is tax transparent - that is, the LLP itself is not taxed on its income or capital gains. Instead the members are taxed on their shares of the LLPs' profits and gains, just as partners in a partnership are currently taxed.

Up until 6 April 2014, all members of an LLP were taxed as self-employed individuals. However, from 6 April 2014, certain members (mainly those receiving a fixed profit share) are now required to be taxed as employees with PAYE and Class 1 National Insurance Contributions ('EEs and 'ERs) being payable on their remuneration from the LLP.

LLPs were primarily intended for use by the professions. However, any type of business operating for profit may use LLPs. An LLP may be suitable for use as a joint venture vehicle or as an alternative to a limited company, particularly for small businesses.

Limited Company

A limited company is a separate legal entity that exists under the authority granted by statute. A limited company has substantially all of the legal rights of an individual and is responsible for its own debts. It must also file tax returns and pay taxes on income it derives from its operations.

Typically, the owners or shareholders of a limited company are protected from the liabilities of the business. However, when a limited company is small, creditors often require personal guarantees of the principal owners before extending credit. The legal protection afforded to the owners of a limited company can be useful.

A limited company must obtain approval from Companies House to use its proposed name. A limited company must also adopt and file a Memorandum and Articles of Association, which govern its rights and obligations to its shareholders, directors and officers.

Incorporating a business allows a number of other advantages such as the ease of bringing in additional capital through the issue of share capital or allowing an individual to sell or transfer their interest in the business. It also provides for business continuity when the original owners choose to retire or sell their shares.

From a tax perspective, the act of incorporation can create advantages via:

• Selling the business to the company at market value and paying Capital Gains Tax (CGT) on the first £1 million of gain at 10%, with the benefit of business asset disposal relief (was entrepreneurs' relief), instead of the normal rate of tax when funds are withdrawn from a limited company. Once the £1 million lifetime limit has been used any additional capital gains on disposal are taxed at 20% if the shareholder is a higher rate taxpayer.

• Saving National Insurance contributions (NICs) by drawing profits as dividends rather than as salary.

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Business Structure – The Pros and Cons

Company	Sole Trader/Partnership
A company must be formally incorporated with a written constitution in the form of a Memorandum and Articles of Incorporation. There is, therefore, an initial setup cost.	There are no formation costs, but a written partnership agreement is advised.
Companies are governed by the Companies Acts. A company must: - - Keep accounting records - Have the accounts audited* - File accounts and an Annual Return with the Registrar of Companies. This information is available to the public. - Keep Statutory Books showing details of shareholders and directors *Your company may qualify for an audit exemption if it has at least 2 of the following: • An annual turnover of no more than £10.2 million • Assets worth no more than £5.1 million • 50 or fewer employees on average	Sole traders and partnerships are not required by law to have annual accounts nor to file accounts for inspection. However, annual accounts are necessary for the HM Revenue and Customs tax returns.
Companies may have greater borrowing potential. They can use current assets as security by creating a floating charge.	Sole traders and partners are unrestricted in the amount and purpose of borrowings but cannot create floating charges.
Shares in a company are generally transferable ownership may change but the business continues.	
Incorporation does not guarantee reliability or respectability but gives the impression of a soundly based organisation. Personally, there may be prestige attached to directorship.	The unincorporated business does not carry the same prestige.
Tax is payable on directors' remuneration paid via PAYE on the 19th of the following month. Tax is paid by shareholders on dividends under the self-assessment rules, although the first £2,000 of dividends are tax free each year. Unless profits exceed £1,500,000, corporation tax is payable 9 months after the year-end.	For a sole trader or partnership, tax is generally paid by instalments on the 31 January in the tax year and the 31 July following the tax year. For an ongoing business, the tax for 2021/22 is payable: first payment on account on 31 January 2022, second payment on account on 31 July 2022, with any final balance due on 31 January 2023. For a start-up business, this is slightly different and covered in more detail later in this publication.
First year losses in a company can only be carried forward to set against future profits.	Start-up losses generated by a sole trader or a partner in the first four tax years can be set against other income of the year or carried back to the three previous tax years, potentially resulting in a tax refund.
The corporation tax rate is currently 19% irrespective of the level of company profits. Budget 2021 announced that the rate would be increased to 25% from 1 April 2023 where profits exceed £250,000 a year. From that date the 19% rate would only apply to profits up to £50,000 a year with a marginal rate of 26.5% for profits for profits between the two new thresholds.	Profits are taxed at 20% on taxable income up to £37,700 for 2021/22 and 40% thereafter with a 45% rate on income over £150,000. Budget 2021 has announced that the personal tax thresholds will be frozen until 2025/26.
There is both employers' and employees' national insurance payable on directors' salaries and bonuses. The NI charge is greater than that paid by a sole trader/partner, but there is no NI charge on dividends.	A partner/sole trader will pay Class 2 NI of £3.05 p.w. (2021/22) and Class 4 NI dependent on the level of profits, 9% up to £50,270 and 2% thereafter.
Where the business owner is both a shareholder and a director, they have a certain amount of flexibility to control their personal tax liability as they only pay tax personally on what they draw out of the company. Many director shareholders pay themselves a low salary to minimise national insurance and extract the bulk of their income by paying themselves dividends. Where they are in receipt of child benefit, they are able to minimise the tax they pay on that income by keeping their income below £50,000.	Sole traders and partners are taxed on their share of business profits irrespective of the amount that they draw out of their business. Consequently, they are less able to control the level of their taxable income compared to a director/shareholder of their own company.

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