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Business structure

To be, or not to be a limited company is a question that frequently rears its head when budding entrepreneurs start planning a new business venture. It's rarely a topic that has a clear answer as there are advantages and disadvantages to a corporate structure and indeed, other alternatives.

In this fact sheet we have listed the most recognised ways to run a business and some of the advantages and disadvantages of the different structures. The most common are:

- Sole trader;
- Partnership;
- Limited liability partnership;
- Limited company with shareholders; and
- Company limited by guarantee.

What are business risks?

Before we list in more detail the advantages and disadvantages of the various structures, it's worth identifying business risks. The two main risk areas are:

- Insolvency – this describes the financial situation of a business where business liabilities are more than business assets.
- Third party risks – causing damage to property or a third party and the costs are not adequately covered by insurance.

What is a sole trader?

A sole trader is the simplest form of business structure available if you want to be self-employed. It's an individual trading under their own name or a business name, and they are personally liable for all the business risks. At lower levels of activity, being a sole trader is a perfectly acceptable form in which to trade.

Advantages:
- Simple to set up.
- Low maintenance costs – no formal filing requirements apart from a tax return.

Disadvantages:
- If your business becomes insolvent, creditors will be able to access your personal assets (including your home) to obtain payment of their debts.
- In the same way, personal assets can be put at risk if third party claims cannot be met by insurance or business funds.
- At higher levels of profitability, it will in most cases pay to incorporate your business to save tax.

What is a partnership?

A partnership recognises that two or more individuals may want to run a business together and still be considered self-employed for tax purposes.

Advantages:
- Provides a legal structure, with a set of rules (a partnership agreement) that will facilitate individuals running a business together.
- Helps to share the responsibility of managing and developing a business.

Disadvantages:
- More complex tax filing required, both the partnership and the partners will be required to file a tax return.
- As with a sole trader structure, if the business becomes insolvent, creditors will be able to access the personal assets of the partners (including their homes) to obtain payment of their debts.
- In the same way, personal assets can be put at risk if third party claims cannot be met by insurance or business funds.
- At higher levels of profitability, it will in most cases pay to incorporate your business to save tax.
- A business partnership involves two or more people to work together. If these relationships break down, dissolving a partnership can be an expensive and time consuming activity.

What is a limited liability partnership (LLP)?

For tax purposes, an LLP is treated the same as a partnership and the advantages and disadvantages listed for a partnership apply to an LLP with one notable exception:

the partners, or members of an LLP have limited liability status. Accordingly, the partners' personal assets are protected from third party claims creditors etc.

LLPs are also required to prepare accounts in a particular format and file a copy with Companies House as well as HMRC. Consequently, the costs of fulfilling these obligations are higher than those for a sole trader or non-LLP partnership.

What is a company limited by guarantee?

In essence, a company limited by guarantee is a limited company with no shareholders. Instead, the persons who set up the company – its members – guarantee to pay a fixed amount into the company if required on the winding up of the company. Usually these guarantees are for small amounts. This type of company is typically used by not for profit organisations and charities rather than trading companies.

What is a limited company (LTD)?

An LTD is a separate legal entity owned by its shareholders and managed by its directors. In most smaller LTDs, shareholders and directors are the same person. Directors are employed by their LTD, they are not self-employed. LTDs are required to pay Corporation Tax on their profits, not Income Tax.

Advantages:

- Provides a legal structure, with a set of rules (the LTD's memorandum and articles of association) that again will facilitate individuals running a business together.
- An LTD structure provides the shareholders, the owners, with limited liability – their personal assets will be protected.
- If a business is profitable, it is likely that an LTD structure will reduce taxation. Director shareholders can apply a mix of salary and dividend payments, thus saving National Insurance, and any retained profits will be taxed at the lower Corporation Tax rate. Compare this to an unincorporated structure, sole trader or partnership, where all the business profits are taxed at Income Tax rates whether the profits are taken out or retained in the business.

Disadvantages:

- More complex tax filing is required, the company will have to submit accounts and a Corporation Tax return, and the directors will be required to file a tax return.
- As well as filing accounts with Companies House, LTDs also have to keep their records of shareholders and directors up-to-date. This is facilitated by the filing of an annual confirmation statement.
- Director/shareholders of an LTD will still run the risk of complications if relationships break down. The formal dissolution or liquidation of an LTD can be an expensive affair.

Which structure is likely to be best for your business?
Readers contemplating their options, for a new or expanding business venture, would benefit from professional advice before making a final decision. We would be delighted to help.

Summary action list

- Identify your commercial risks. If they are significant, and cannot be adequately covered by insurance, a limited liability partnership or company may be your best option.
- Produce a business plan that forecasts your first two or three years profits. If projected profit levels are below £25,000, and commercial risks are low, then a sole trader arrangement may be your best option.
- Seek professional advice before settling on a course of action. Very often, it is the risks you don't know about that will defeat the best laid plans.
- And don't forget, if you find yourselves working in an inappropriate structure, you can always change.

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