Briefing Notes

Mercer & Hole

BUSINESS STRUCTURES

Having made the decision to start your own business, it is important to pick the best structure from a legal and tax perspective. The most suitable structure for you will depend on both your current personal situation and your future plans. The decision you make will have implications for the way you are taxed, your exposure to creditors and other matters.

The options you have are as follows:

Sole Trader

This is the simplest and administratively cheapest way of trading. There are only a few formalities to trading this way, the most important of which is informing HMRC. You are required to prepare accounts each year and they will form the basis of how you pay your tax and national insurance. Any profits generated as a sole trader are automatically yours. The business of a sole trader is not distinguished from the proprietor's personal affairs so that if there are any debts, you are legally liable to pay them.

Partnership

A general partnership is an extension of being a sole trader. Here, a group of two or more people will come together to build a business. The partners will agree to share the joint profits and interests in capital assets in pre-determined percentages. It is advisable to draw up a Partnership Agreement which sets the rules of how the partners will work together.

Partners are taxed in the same way as sole traders, but only on their own share of the partnership profits. There is no restriction on exposure to business creditors; partners are 'jointly and severally' liable for the partnership debts.

One key aspect of partnership taxation is that for capital gains tax purposes the partnership is transparent i.e. any assets are deemed to be owned by the partners individually and taxed accordingly.

However, this may not be the case for Inheritance Tax where holding investments in a partnership may jeopardise business property relief.

Limited Liability Partnership (LLP)

An LLP is a corporate entity that is taxed in the same way as a general partnership (as long as it is active). The advantages of an LLP are commercial; each member's (partner's) liability is limited to the amount of their partnership capital. Again, a Members' Agreement should be drawn up to clarify the position on capital, profit shares, etc.

Limited Company

A limited company is a legal entity separate from its owners. It can trade, own assets and incur liabilities in its own right. Ownership of the company is recognised by owning shares. When a company generates profits, they are the company's property. Should you wish to extract money from the company you must either declare a dividend as an owner, or pay salary (under PAYE), benefits and pension contributions as an employee/director. The advantage to you is that you can have a balance of these to minimise your overall tax liability.

Companies themselves pay corporation tax on their profits after paying remuneration but before dividends. Effective tax planning requires profits, remuneration and dividends to be considered together.

If relevant to your trade you should be aware that only companies can claim the tax reliefs available on patent income and research and development costs.

There are additional administrative factors when running a company, such as the requirement to prepare statutory accounts and other company secretarial obligations.

A significant commercial advantage of running your business through a limited company is that your personal liability is limited to the nominal share capital you have invested. The position is similar in a LLP whereas as a sole trader or a partner in a conventional partnership you will have unlimited liability for the debts of the business.

Early years

If trading losses are expected in the early years it may be beneficial to trade as a sole trader or a partnership/LLP as these losses can be set against other personal income in the year of the loss or carried back up for up to three years to set against other income for those years. This may create a tax repayment.

However, losses arising in a newly formed company can only be carried forward against future profits. This may create a cashflow disadvantage.

If a trade is set up as a sole trader or partnership, consideration can be taken on whether to transfer the trade to a company once profits increase.