Which legal structure is best for my business?

Before starting your business, you will need to choose a legal structure/entity which suits you best. It is important to remember that should your circumstances change relating to the size, functionality, and liability of the business, you are able to change the legal structure in the future if desired.

The three most common types are sole trader (often referred to as self-employed), partnership (two or more sole traders setting up) and a private limited company.

In all cases there is no impact on employing staff or VAT rules regardless as to the structure you select.

Sole trader

This is the easiest option to set up, it requires a simple completion of a structured form on Gov.uk. Sole traders register with HMRC and complete an annual self-assessment. This will tell HMRC what their income (sales) is over the year together with completion of allowable expenditure and they are taxed accordingly for income tax and national insurance based on a range of tax thresholds.

Sole traders do not receive a wage or salary as this would imply that tax is deducted at the same time. Instead, drawings are deducted from business account for personal use. The tax is calculated when completing the self-assessment and is purely based on trading – sales less allowable expenses in addition with any other personal income and taxes paid such as employment.

As a sole trader you are personally liable for any business debts. It is therefore a simple business structure and suitable for businesses with low financial risks. There are also the least number of regulations to adhere to.

Partnership

The two or more partners involved assume the same responsibilities as those taken on by a sole trader, but the liabilities are split between them or according to the partnership agreement made between the partners. The partnership will have to submit accounts to HMRC via a nominated partner, in addition to the self-assessments submitted by each individual partner.

It is important to formulate a written agreement, and for this to be signed by all partners. Regardless of how close you are personally; it is good sense to have the terms of the partnership clearly recorded from the outset to avoid potential conflict later. Agreement can include how losses and profits are shared, roles, responsibilities and accountability, decision making processes within the business and if a partner wants to leave the partnership.

Private limited company by shares

A private limited company has a separate legal identity to its owner. This means that as an owner you have limited liability for financial claims. This gives you more protection for your personal finances than when you are a sole trader. Be aware of exceptions to the rule including misconduct, obtaining money by fraudulent means and when making personal guarantees, often found in business contracts.

As well as registering with HMRC a limited company also needs to be registered with Companies House which can be found on Gov.uk. Your personal information and accounts will be published, and anyone can look this up in the public domain. Accounts must be submitted to Companies House every year.

As a limited company, legally another company cannot set up using the same business name. It can be set up with only one person who will be the director and the only shareholder. When the company is incorporated, shareholders buy shares issued by the company. The director is in essence an employee of the Limited Company, a payroll system must set up as the director's salary deductions are subject to tax and national insurance contributions – pay as you earn (PAYE). Additional payments can be taken from the profits of the business in the form of dividends. The business is subject to corporation tax from its profits.

Limited liability partnerships (LLP)

A partnership can also be limited by registering with Companies House, this gives limited liability for business debts. This is a limited liability partnership (LLP). A partnership agreement is also best practice for LLPs.

Not for profit distribution organisations

A broad term for all independent organisations whose purpose is something other than to make private profit for directors, members, or shareholders. Examples are provided below.

Community interest companies

Community interest companies (CICs) are companies that trade commercially as a social enterprise. They have a clear social objective and have restrictions on how they distribute their profits. A CIC is registered with the Office of the Regulator of Community Interest Companies.

Private limited company by guarantee

A private company limited by guarantee does not have shareholders and cannot distribute profit to its members. The profits (surplus) are re-invested into the company instead. The company is incorporated with Companies House and has voting members. It is controlled by a group of directors, who can be paid or unpaid.

Charitable company

Establishing a charitable company involves registering with the Charity Commission as well as Companies House, and then submitting your annual report and accounts to both organisations annually.

Cooperative society

The purpose is to provide services to its members rather than the wider community. They must be based on the cooperative values of self-help, self-responsibility, democracy, equality, equity, and solidarity.
Membership to a cooperative society is open to people who use the services provided by the society, or work for the society, and profits may be distributed to members providing this is not the primary purpose of the organisation.