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Date produced: 29 Jan 2014

qLegal Toolkits

UK Company Structure

Why it is necessary to create a legal entity and structure for a business and what is important to remember when setting this up and starting a business?

Beginning a new business is an exciting and challenging process, and it is extremely important to figure out the main legal issues involved. After a good business idea springs to mind, the choice of the right structure to realise it is an essential step to take, and the right choice depends on the specific needs, goals and expectations of the business. A good understanding of business codes of practice, laws and regulations is the safest way to avoid trouble in the future.

In order to sign contracts, obtain a bank account etc., a business needs to have a formal structure and a legal personality, whether it is carried on as a sole trader, partnership or company.

Is it better to incorporate or to set up an unincorporated organisation? How many people will be involved, how will they contribute and how will they be rewarded? What are the alternatives available for running a particular type of business? Are there any restrictions on retaining profits? What type of tax advantages and disadvantages can be expected? What type of liability may arise in case of trouble?

This short guide provides simple and quick answers to these and many other questions by explaining the principal legal possibilities available for running a business in UK.

1) Main types of business structure in the UK

There are three basic types of business ownership:

- Sole proprietorship or sole trading;
- Partnership;
- Company.

The structure you choose will define legal responsibilities and duties, like the paperwork you must fill in to get started, the taxes you will have to manage and pay, and the profits which may be made and withdrawn.

- **Sole trader**

- 1) Legal structure**

Sole trading is where the business is owned by one individual who has complete control and responsibility over the way he runs the business. This is known as being 'self-employed'. You can keep all your business' profits after you have paid tax on them. A sole trader is the simplest form of business to start – all that is needed is the first customer! A sole trader is also personally liable.

- 2) Registering as a Sole Trader**

In order to become a sole trader you will need to fulfil certain requirements.

Use the right name and put it on paper

If you are going to trade under a name which is different from your personal one you must display the name/s of the owners and an address where documents can be served on all business stationery and at your premises. It is not compulsory to register a business name but you can do so with the National Business Register. You also need to be careful about choosing a name since the wrong name can get you into difficulties.

Inform the authorities

You must register as self-employed for income tax and national insurance contributions with the HMRC (HM Revenue and Customs) within three months from starting up. This period starts from the last day of your first month of trading and if you fail to meet this timeframe you can face a £100 fine plus interest on any taxes due. You can register online, by phone or by post.

While it is not possible to register in advance, it is important that you inform HMRC as soon as you start working. Upon registration, you'll need to provide the following information: name, address, national insurance number, date of birth, telephone number, email address, the nature of your business, start date of self-employment, business address, business telephone number, your Unique Tax Reference (UTR), the full name and date of birth of any eventual business partner.

- 3) Legal responsibilities**

As a sole trader you are personally responsible for:

- any losses and debts your business makes;
- bills for anything you buy for your business, like stock or equipment;
- keeping records of your business' sales and expenses;
- sending a Self-Assessment tax return every year;

- paying income tax on the profits your business makes and National Insurance.

4) Tax responsibilities

In order to submit tax returns to HMRC firstly you will need to fill in a self-assessment registration form and inform HMRC about your business. You should register by 5 October following the end of the tax year you need to send a tax return for. This way, you will have enough time to complete registration before the tax return and any taxes are due. You may have to pay a penalty if you register late. Once this is done, HMRC will set up tax records for you and will send you a Unique Taxpayer Reference (UTR).

Usually you get a letter from HMRC in April or May which is telling you to send a tax return. You should send your tax return, even if you do not have any tax to pay, otherwise you will face penalties for a late tax return. You may be charged interest on the penalty and any tax you owe - currently 3%. If you owe any money by the end of the tax year (April), you must pay that amount by January 31 of the following year. The payment deadline is the same whether you file online or on paper.

• Limited companies

1) Legal structure

A limited company allows running a business through a legal entity separated from its members. This means that it can carry on business in its own name and with its own identity, as it enjoys full legal personality. A company can autonomously enter into contracts, incur debt, own property, borrow or lend money, and sue or be sued without involving its members' liability.

There are four types of company structures available under UK law:

- Private companies limited by guarantee;
- Private companies limited by shares (known as private limited companies or LTD);
- Public limited companies (known as PLC);
- Community interest companies.

2) Companies limited by guarantee and Companies limited by shares

Private companies limited by guarantee are established by a number of members acting as guarantors, who are responsible for the liabilities of the company up to a certain amount of money only in case of insolvency. These companies are especially suited for a small business enterprise rather than a large business model.

Private companies limited by shares are established by a group of people who own 'portions' or shares of the company: thus, they are called shareholders. If such a company goes bust, the shareholders are not liable for anything more than the nominal value of their shares. Shareholders are not entitled to run the company, unless they are members of the Board of Directors, a panel responsible for the daily business management. There are certain restrictions on being a Director in the Board, as well as limits on the transfer of shares.

Public limited companies are similar to private companies limited by shares in structure, although their shares can be transferred freely. A *plc* can be either listed or unlisted: when listed, its shares are traded in a public market known as the Stock Exchange. As the minimum capital required for establishing a PLC is £ 50.000, it is commonly used to incorporate big businesses.

3) Community interest companies

Community interest companies (CIC) are particular entities limited by shares or guarantee, which are commonly used to run 'social enterprises'. These businesses are set up to pursue a social and community interest, such as the performance of charitable activities (although they are not registered charities).

In order to ensure that the business is truly run in the interest of the community and not exclusively of private shareholders, the company must demonstrate a community interest to the regulator and there are restrictions on the transfer of company's assets, as well as to the distribution of profits. These limits are set by the Regulator of Community Interest Companies, which is the public authority responsible for establishing specific rules applicable to CIC, and which recognises them as pursuing community interests.

4) How to establish and register a company: requirements and procedures

A sequence of steps should be followed in order to establish any company:

- Members or shareholders subscribe to a memorandum of association: through this document they agree to become members of the company.
- The rules governing the company will be agreed in an article of association: this document defines essential features such as the process for appointing directors, their duties and powers, the instruments for raising finance, as well as the company's purpose.
- An application shall be submitted to the Companies House. This will indicate the name of the company, the location of the company's office, the limits to the liability of the members, whether the company is to be either private or public, the agreed article of association, and a statement containing the particulars of the first directors and secretaries. Finally, specific details must be provided with regard to the type of capital chosen.
- Provided that all legal conditions are fulfilled, the Companies House will emanate a certificate of incorporation.

5) Legal responsibilities

Companies are run by a director or a board of directors who are responsible for the daily management of the company, and the law imposes the following duty on them:

- A company must have one or more directors
- directors must act in accordance with the company's constitution and in the interest of the company itself, and they are personally responsible for company's compliance with the law;

- directors can exercise only the powers conferred by the article of association, and they shall take responsible decisions promoting the success of the company;
- directors shall exercise reasonable care, skill and diligence, avoiding conflict of interest and disclosing any interest they may have in company's transactions.

Directors will be held liable for any damage suffered by the company if they act with negligence or if they infringe their duties. Serious offences may result in criminal conviction or disqualification.

6) Tax responsibilities and special incentives for start-ups

Companies are subject to Corporation Tax. As a result, directors must notify the HMRC about the creation of the company. The infringement of these rules has severe consequences, such as the imposition of penalties and possible prosecution against directors.

Within 9 months and 1 day of the end of each financial year, the company is to pay the correct amount of Corporation Tax calculated on not exempted profits: these include trading profits, investment profits and capital gains resulting from yearly financial reports.

Within 12 months of the end of the financial year, a Company Tax Return shall be submitted to the HMRC: this is a report containing the company financial accounts (or statutory accounts), and separate calculations and computations of payable taxes. The amount of tax payable depends from the total profits produced: from 2015 on, the general tax rate will be set at 20%.

A number of tax incentives are designed to encourage investors to provide resources to newly established business, and to guarantee high level of profits for start-ups which invest in research and development:

- o **Enterprise Investment Scheme (EIS)**

The Enterprise Investment Scheme can help a company raise finance by providing tax relief to investors who buy shares of the company. Investment in start-ups always comes with a high risk and the tax relief is intended to offer some incentive for taking that risk. The EIS offers both income tax and capital gains tax reliefs to investors who subscribe for shares in companies that qualify. Income Tax relief is available for investors at 30% of the cost of the shares, on a maximum annual investment of £1,000,000. Capital Gains Tax can be adjusted by reinvestment of the money EIS shares within a certain amount of time. If Income Tax relief is given and the shares are held for a qualifying period, you would be able to claim an exemption from Capital Gains Tax. Losses from the sale of shares can be adjusted against Income Tax liability, if Income Tax relief was given and has not been withdrawn.

- o **Seed Enterprise Investment Scheme (SEIS)**

This scheme integrates the EIS, and it is designed to guarantee primary financial resources to small early established companies. The scheme is based on a tax relief for investors that acquire and retain (for at

least 3 years) shares of companies which have less than 25 employees and £ 200,000 assets, and which are not quoted in the Stock Exchange. A detailed range of conditions is set in legislation for particular activities.

- **Patent Box**

The Patent Box scheme gives reduction of 10% in the rate of corporation tax on profits from patents. You can only benefit from the Patent Box if:

- (i) your company is liable to Corporation Tax;
- (ii) it makes a profit from exploiting patented inventions;
- (iii) your company must also own or exclusively license the patents, and
- (iv) it must have undertaken qualifying development for the patent by making a significant contribution to either the creation or development of the patented invention or a product incorporating the patented invention.

- **Partnership**

- 1) Legal structure**

A partnership is formed by two or more people deciding to work and do business together. What is essential is the intention to jointly share the profits from that business. Persons jointly working together as partners are referred to collectively as a “firm”.

Partnership is different from a sole trading because there is more than one person involved, but at the same time it is not the same as a company either, which has its own legal identity independent from its members. A partnership model is ideal for small business enterprises that do not require too much risk or liability.

Due to differences in members’ liability, there are two types of partnerships within UK law:

- a) General partnership;
- b) Limited partnership (LLP).

- 2) Procedure of establishment**

A partnership may be formed either by a written agreement or by conduct of parties simply working together. It is certainly advisable to have a written agreement providing details of reciprocal partners’ rights and liabilities.

A written agreement is also helpful to decide whether a specific property belongs to the partnership itself or to an individual partner. This is important because when a partnership is brought to an end there may be some concern and disputes regarding distribution of property and assets. Written agreements also contain necessary clauses on how the partnership will be structured and also how it should be brought to an end

A partnership does not need to be registered like a limited company, but it must notify HMRC for tax purposes. Moreover, it cannot use in its name anything resembling a link with the government or otherwise prohibited by law.

3) Legal responsibilities

In general partnerships, members are individually liable for all debts and obligations of the firm, as well as for taxes. General partners are legally responsible to each other: this means that they are individually liable to other partners if they act against firms’ interests, and they are liable for each other’s business acts with the outside world. For example, if a partner does anything against the interest of the firm and makes a profit for himself out of it, the firm is entitled to such a profit.

In limited partnerships (LLP), members enjoy a reduced liability for business debts. LLP is a hybrid between a partnership and a company, in structure, as it is itself responsible for business liabilities. The liability of the partners is restricted and a partner’s own personal assets are not liable to be attached and sold in order to pay the firm’s debts. Limited partners don’t have several responsibilities for each other’s actions, and they cannot lose more than what they invested.

4) Tax responsibilities

A partnership needs to be registered for tax purposes with HMRC and a partner has to be chosen as a nominated partner, the one person who shall be responsible for managing the firm’s accounts and tax formalities.

Partners must pay self-assessment tax for their share of the firms’ profits. As it resembles an individual running a business and making profit, a partnership is to be found where individuals work jointly and make profits according to the decided profit sharing basis.

• Advantages and disadvantages of different business structures

| | Advantages | Disadvantages |
|--------------------|--|--|
| Sole trader | <ul style="list-style-type: none"> • Low cost • Easy way to set up • Full control retained • Very little financial reporting | <ul style="list-style-type: none"> • Full liability for debts • High taxes • Lacks credibility in the market |
| Company | <ul style="list-style-type: none"> • Less personal financial exposure due to the corporate veil • Tax regime • Ability to work for corporate clients • Flexible structure and variety of options | <ul style="list-style-type: none"> • Administrative and regulatory demands are heavier • Annual accounts and financial reports must be placed in public domain |
| Partnership | <ul style="list-style-type: none"> • More potential to raise finance • Possibility to limit liability | <ul style="list-style-type: none"> • Can be messy to wind up • Taxes are to be paid on individual basis |

2) Alternative ways of running a business

There are a number of alternatives that can be used to run a business under UK law: the choice between one of these models depends from the characteristics of the performing activity, as well as from the availability of financial resources and the number of people involved.

- Co-operatives & Industrial and Provident Societies

When the business is to be run by a group of people willing to meet common needs or aspirations, a co-operative is a good option. This is a jointly-owned and democratically controlled enterprise, with a particular and flexible form of organisation. As co-operatives don't have an autonomous legal structure, they must be established using one of the classic legal forms, such as a company or an IPS (*see below*). There are a variety of co-operatives, such as worker co-operatives, consumer co-operatives, service co-operatives, housing co-operatives and so on.

Industrial and Provident Societies (IPS) are incorporated legal entities supervised by the Financial Conduct Authority (FCA). They can be classified into two categories:

- 1) *bona fide* co-operatives: these societies operate for the mutual benefit of their members, and they have particular features such as a democratic voting system, limits to the distribution of profits and to the distribution of assets;
- 2) Societies for the benefit of the community: these IPSs can benefit people other than their members, and they can operate as charitable organisations.

3) Further informations

A number of helpful sources are available on web pages, aimed at helping new entrepreneurs. Here is a few:

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| Establishing a new business | http://www.smarta.com/advice/starting-up/starting-your-own-business/ https://www.gov.uk/business-legal-structures/overview http://www.uk.coop/sites/storage/public/downloads/simplylegal_0.pdf |
| Sole traders | http://startups.co.uk/registering-as-a-sole-trader/ http://startups.co.uk/how-to-register-as-a-self-employed-sple-trader-or-freelancer http://www.gov.uk/set-up-sole-trader |
| Companies | https://www.gov.uk/business-legal-structures/limited-company http://www.legislation.gov.uk/ukpga/2006/46/contents https://www.gov.uk/limited-company-formation http://www.companieshouse.gov.uk/about/gbhtml/gp1.shtml |



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|------------------------------|---|
| Co-operatives and IPS | http://www.uk.coop/what-co-operative http://www.uk.coop/starting-co-operative-journey/getting-organised http://www.fsa.gov.uk/doing/small_firms/msr/societies |
| Partnership and LLPs | http://www.companieshouse.gov.uk/infoAndGuide/llp.shtml https://www.gov.uk/set-up-business-partnership http://www.bgateway.com/starting-up/form-a-company-or-business/set-up-and-register-a-limited-liability-partnership/ |
| Information on taxes | https://www.gov.uk/limited-company-formation/set-up-your-company-for-corporation-tax http://www.hmrc.gov.uk/compliance/factsheets.htm http://www.hmrc.gov.uk/businesses/index.shtml http://search2.hmrc.gov.uk/kb5/hmrc/forms/corporationtaxforms.page http://www.hmrc.gov.uk/ct/getting-started/new-company/start-up.htm http://www.hmrc.gov.uk/ct/getting-started/deadlines.htm http://www.hmrc.gov.uk/seedeis/index.htm http://www.hmrc.gov.uk/eis/ http://www.hmrc.gov.uk/ct/forms-rates/claims/patent-box.htm |

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