Legal Factsheet: Choosing the Right Legal Status

When you start a new business you need to decide what its legal status will be. This factsheet outlines the different types of legal status and what their various advantages and disadvantages are.

Types of legal status

- ***Sole trader***

You are both the owner of the business and the person who runs it; the business largely depends on you and your skills. As far as the HM Revenue and Customs (HMRC) is concerned, all a sole trader needs to do is register as self-employed. They should also register for VAT if they think their turnover is going to reach the current stipulated amount (£79,000 in 2013-14). The majority of people starting up a business choose this legal status.

- ***Partnership***

Two or more people 'carry on a business in common with a view to profit' (Partnership Act 1890). They share all the responsibilities and risks as well as the profits. Each partner needs to register as self-employed (see above) and it is recommended that a formal partnership agreement is drawn up (though there's no legal requirement to do this).

- ***Limited company***

The business has its own separate legal existence. This means that its finances are separate from those of its owners, who therefore are not normally liable for the business's debts. Limited companies are regulated by a lot of legislation, and creating one involves drawing up a memorandum and articles of association and registering with the Registrar of Companies, or Companies Registry in Northern Ireland. You will also need to set up a PAYE scheme.

The quickest and cheapest way to start a business as a limited company is to buy an existing company via a company registration agent, solicitor or accountant. The paperwork will already be in place and you can start trading almost immediately.

- ***Limited liability partnership (LLP)***

This differs from an ordinary partnership in that each partner's liability is no more than the money they have invested in the business and the sum of personal guarantees they have given to raise money.

- ***Community interest company (CIC)***

CICs have only existed for a few years and are fairly rare. A CIC is essentially a limited company dedicated to social enterprise; its assets and profits can only be used in the interests of the community. To set one up or convert to being one, you need to register with the CIC Regulator and show that:

- Your business is socially motivated
- Any existing shareholders approve of the change to CIC status.

The advantages and disadvantages of each of these types of legal status are summarised in the table on the next page.

Changing legal status

Changing the legal status of your business is perfectly possible, but it can be time-consuming and expensive. It is usually best to think about the legal status that will most suit your requirements right at the start and get this established when you set up your business.

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Legal status	Advantages	Disadvantages
Sole trader	▪ Can start trading immediately without much initial investment ▪ No accounting or business audits necessary (but you'll need to keep accurate records of income and expenses) ▪ Class 4 National Insurance Contributions are payable as a percentage of your net profits ▪ You have complete control over how the business operates and can take all the profits	▪ Unlimited liability for debts, so if the business loses money you may have to sell off your personal assets ▪ Can be difficult to obtain capital to expand • As the business depends on you, it doesn't have much value in itself ▪ Growth limited to what you personally are capable of ▪ You are entitled to fewer social security benefits than an employee
Partnership	▪ Combination of talents may lead to more success ▪ Day-to-day management easier ▪ Spending time away from business easier ▪ The business can survive if one partner dies or leaves	▪ Unlimited liability for debts (as above) ▪ All partners are jointly liable for debts, so if one partner is dishonest it can cause problems for the others ▪ Disagreements can lead to the end of the business ▪ The business can dissolve if one partners dies or leaves.
Limited company	▪ Owners not personally liable for debts of the company ▪ Can raise capital by issuing shares ▪ The business's survival does not depend on the survival of anyone member ▪ The overall tax bill may be lower; salaries are taxed at usual rate but company profits are subject to lower corporation tax rate ▪ People outside the business may regard it as more professional	▪ Setting up is more complicated and costly than for sole traders and partnerships ▪ An owner-director pays **NI** contributions as an employee and their company must pay them as an employer ▪ Certain information must be filed annually with the Registrar of Companies, or Companies Registry in Northern Ireland
Limited liability partnership (LLP)	▪ Each partner's liability for business debts is limited to the amount they have invested or guaranteed	▪ Certain information must be filed annually with the Registrar of Companies, or Companies Registry in Northern Ireland ▪ At least two of the partners must be 'designated members', giving them extra responsibilities
Community interest company (CIC)	As for limited companies, plus: ▪ Access to funding or grants aimed at social enterprises ▪ Possible marketing advantages to branding as a social enterprise	Similar to limited companies, but: ▪ Certain information must be filed annually with the CIC Regulator