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WHY YOUR ENTERPRISE NEEDS TO THINK ABOUT A CORPORATE STRUCTURE?

What Will This Guide Cover?

- The different models of corporate structures available: sole trader, general partnership, limited liability partnership, private company limited by shares and community interest company;
- How to set up each kind of corporate structure;
- The basic legal and tax liabilities connected with each model;

What Questions Does This Guide Answer?

- What is a corporate structure?
- What are the different models of corporate structure?
- What are the different legal and tax responsibilities for each model?
- How is a corporate structure set up?
- What do I need to report to Companies House, the official Registrar of Companies in the UK?
- How does a corporate structure affect personal liability?

When starting a business, you need to choose a corporate structure. The corporate structure determines:

- The requirements for starting a business under that structure
- The paperwork required to form and maintain each structure
- Tax liabilities
- Liabilities in relation to business losses
- How profit is earned and divided

I. <u>Corporate Structure Options</u>

a) <u>Sole Trader</u>

A sole trader is responsible for running his or her business and for meeting the legal requirements that come with it. As a sole trader, you can keep all of your profits after tax; however, you are also personally responsible for any debts of your business. Debts of the business include any losses the business makes, anything bought for the business (such as stock and equipment) and also any wages owed to staff as well as any personal injury claims against the business. Even though you are a 'sole' trader this does not mean you cannot take on any staff - you can have staff as part of your business.

A sole trader doesn't have to file any legal documents with the Companies House in order to do business as a sole trader and also doesn't have to have any internal, private legal documents, other than employment contracts or freelancer contracts with any staff.

How to Become a Sole Trader

You will be a sole trader by default if you are a person operating a business and you have not set up an alternative corporate structure and are not operating in partnership with another person.

Tax Responsibilities

A sole trader is considered to be 'self-employed'. As a result, you must register with HM Revenue & Customs (HMRC) for self-assessment of personal income taxes as soon as possible after starting your business.

If you are a sole trader, you need to pay personal income tax and National Insurance, called Class 4 National Insurance, on your business's profits. Unless your profits are very low, you also have to pay Class 2 National Insurance. All these taxes must be paid each year by 31st January following the end of the tax year (5th April) or you risk incurring penalties from HMRC.

Once you have registered for self-assessment you will usually receive a letter in April or May from HMRC telling you to send a tax return. You should always send your tax return, even if you do not have any tax to pay.

You can submit your tax return online or through a paper application. However, deadlines for paper applications are much earlier than that of online applications. If you miss the deadline for a paper application, you should submit your return online.

Legal Requirements

A sole trader business is simple to set up legally, although certain trades may need a licence. These include nightclubs, taxi and car hire, restaurants, pet shops, indoor sports venues, adult shops, street trading, hotels, pet kennels, nursing homes, waste management, weapon sales and money lending. A license can be obtained from the relevant local authority.

You should also look into any relevant legislation relating to environmental and health and safety requirements. Also check the planning and building regulations relating to your premises.

Liabilities

In the situation of insolvency, a sole trader is personally liable for any debts (liabilities) owed both personally and by his or her sole trading business. Business creditors can seek personal assets as well as business assets to repay the debt owed. Similarly, personal creditors can pursue business assets of a sole trader to repay a debt owed by a sole trader.

b) General Partnership

The Partnership Act 1980 defines the word 'partnership' as "the relation which subsists between persons carrying on a business in common with a view of profit". This excludes any entity which has been incorporated and is regarded as a company.

If you set up a business with a friend and intend to make it a profitable business, then you are involved in a partnership, and partnership law applies. This is true even if there is no written partnership agreement. However, if you belong to a non-profit seeking club, such as a small local football club or community organisation, that does not intend to be profit making, then this is classed as an association and not a partnership.

How to Set Up a Partnership

Although it is easier to set up a partnership than most other business models, there are still a few legal requirements to be met. It is recommended to draw up a partnership agreement to protect yourself in case of an unresolvable dispute or dissolution of the partnership business. However, the partnership agreement does not have to be filed with the Companies House as it is an internal and private document for the partners.

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Tax Responsibilities

In a business partnership, you are running a business as a self-employed individual but all the partners share responsibility for the business. You can share all the profits between the partners, and each partner pays tax on his or her share of the profits.

The nominated partner must keep business records and manage and send the partnership's tax return. The taxes which apply to a partnership are the same as that of a sole trader except that the liability for tax is shared between the partners.

- The nominated partner must also register the partnership and themselves for self-assessment with HMRC. The other partners register with HMRC separately (they usually do this after the partnership is registered with HMRC). Both the nominated partner and individual partners are responsible for:
- Sending their personal self-assessment tax return every year
- Paying income tax on their share of the partnership's profits
- Paying their National Insurance

Legal Requirements

You are personally responsible for your share of:
- Any losses your business makes
- Bills for things you buy for your business, like stock or equipment.

A partner does not have to be an actual person. For example, a limited company counts as a 'legal person' and can also be a partner in a partnership.

Liability

A partnership is set up using the funds of the partners. Partners then share the liability, the profits and the responsibility for how the business is run. In the situation of insolvency, partners are personally liable for any debts (liabilities) owed both personally and by their partnership. Business creditors can seek personal assets as well as business assets to repay the debt. Similarly, personal creditors can pursue business assets of a partnership to repay a debt owed by an individual who is a partner.

c) Limited Liability Partnership

Although given the "partnership" label, a Limited Liability Partnership (LLP) is in fact a body corporate. This means it is similar to limited companies to the extent that it has a legal personality separate from its members, with no restrictions on the kind of business it can transact. Importantly, separate personality means that it is the LLP, and not its members, which will be liable to third parties.

How to Set Up an LLP

An LLP is incorporated by delivering the appropriate form to Companies House.

Two or more people need to subscribe their names to an incorporation document. Although there is no set format, a solicitor, accountant or formation agent should be contacted to ensure the document satisfies all the requirements, which includes a declaration of compliance and the following information:

- The name of the LLP
- Where its registered office is
- The name of the incorporators
- Who the members are.

Incorporation fee, Software: £10, Paper: £40

https://www.gov.uk/government/publications/companies-house-fees/companies-house-fees#llp-inc

The incorporation document can be simply a standard partnership agreement modified for the purpose. Most LLPs prefer a detailed agreement to protect members' interests and in order to replace certain terms implied by law.

Members of an LLP are the people who subscribe their names to its incorporation document – here, the partnership agreement. A member joins an LLP by agreement with existing members. There is no particular form to complete. In the absence of a specific clause in the partnership agreement to the contrary, a member may exit an LLP by giving reasonable notice to the other partners.

Members are not considered to be employed by an LLP unless they would be regarded as salaried partners in a normal partnership. A partner in a partnership cannot also be an employee of the business, because a partner cannot employ themselves.

Tax Responsibilities

An LLP is treated as a partnership for capital gains tax and income tax purposes, despite being a body corporate, as there is no tax liability at the level of the LLP itself. Profits are taxed on individual members of an LLP in accordance with their profit share entitlements.

Relief is provided from stamp duty on transfers of property to a newly incorporated LLP, to aid the transfer from an unincorporated partnership to an LLP.

Members who are natural persons (rather than corporate entities themselves) are treated similarly to self-employed people.

Legal Requirements

Although an LLP is treated as a partnership for most tax purposes, it is subject to much of the law relating to companies and insolvency. As such, LLPs need to submit annual returns, appoint auditors, prepare and file accounts and comply with accounting standards.

Liability

Members in an LLP are protected by the concept of limited liability that is applied to bodies corporate. A member's liability is limited to what he or she has invested in the company and no more. A member's personal assets cannot be sought by creditors unless that partner has given a personal guarantee to a creditor.

d) Private Company Limited by Shares

A private company limited by shares has shareholders, and the liability of the shareholders to creditors of the company is limited to the money the shareholders invest in the company. A shareholder's personal assets are protected in the event of the company's insolvency, but money they have invested in the company will be lost. The company is run by directors rather than the shareholders themselves, although shareholders may also be directors.

How to Set Up a Private Company Limited by Shares

All limited companies must pay an application fee and be registered (incorporated) with Companies House. To do this, you need:

- The company's name and registered address
- At least one director
- At least one shareholder
- Details of the company's shares - known as 'memorandum of association'
- Rules about how the company is run - known as 'articles of association'
- Application fee: £12

https://www.gov.uk/limited-company-formation/register-your-company

You can register your company online but only if the company is limited by shares and uses the model articles of association. Alternatively, you can register by post - you must do this if you change the model articles or use your own drafted articles.
You can also use an agent such as a solicitor to incorporate the company for you.

Tax Responsibilities

A limited company must pay corporation tax on its profits for each year it trades. This tax has to be paid to HMRC by nine months and a day after the end of the financial year. So, if your company prepares accounts to 31st March each year, then any corporation tax is due by 1st January the following year.

The company must also file a form called a ‘corporation tax return’ to HMRC each year, showing how its tax was worked out. Usually, your accountant files this for you, or you can use HMRC’s free software to create and file your return.

The corporation tax return is not due until 12 months after the end of the financial year, although most companies do not wait as long because their corporation tax is due three months before this.

Running your business through a limited company can result in you paying less tax than if your business is a sole trader, but there are a lot of extra considerations to make. If you have any doubt, ask a solicitor for advice.

<u>Legal Requirements</u>

Choosing to run your business as a company gives you the benefit of limited liability which is a form of legal protection for shareholders that prevents individuals from being held personally responsible for their company's debts or financial losses. In other words, investors' and owners' private assets are not at risk if the company fails. However, companies are subject to more rules compared to other business entities. This is a summary of some of the main requirements, although it is not an exhaustive list.

Directors: When you register your company it must have at least one director. A director is legally responsible for the running of the company. Directors have certain duties which they must abide by which are outlined in the Companies Act 2006, for example:

- Duty to act within your powers as a company director
- Duty to promote the success of your company
- Duty to exercise independent judgement
- Duty to exercise reasonable care, skill and diligence
- Duty to avoid conflicts of interest
- Duty not to accept benefits from third parties
- Duty to declare interest in proposed transaction or arrangement with the company

<u>Statement of Capital:</u> When you register a company you need to make a ‘statement of capital’. This is:

- The number of shares the company has and their total value - known as the company's 'share capital'
- The names and addresses of all shareholders - known as 'subscribers' or 'members'

Articles of Association: When you register your company there is a requirement of a document known as the articles of association. These are the rules about running the company that shareholders and directors must agree to. Most companies use the model articles but this is not necessary and you may use articles that have been drafted specifically for your company. It serves as the company's constitution and outlines the directors' powers and shareholders' rights

Change of Information: You must inform the Companies House if you want to change your company's registered office address. If the change is approved, they will tell HMRC. Your company's new registered office address must be in the same part of the UK that the company was registered (England, Wales, Scotland, Northern Ireland).

You must inform the Companies House within 14 days if you make changes to:

- Where company records are kept
- Directors or their personal details, like their address
- Company secretaries (appointing a new one or ending an existing one's appointment)

Record Keeping:

You must keep details of:

- Directors, shareholders and company secretaries
- The results of any shareholder votes and resolutions
- Promises for the company to repay loans at a specific date in the future ('debentures') and who they must be paid back to
- Promises the company makes for payments if something goes wrong and the company is at fault ('indemnities')
- Transactions when someone buys shares in the company
- Loans or mortgages secured against the company's assets

Accounts:

You must keep accounting records that include:

- All money received and spent by the company
- Details of assets owned by the company
- Debts the company owes or is owed
- Stock the company owns at the end of the financial year.
- All goods bought and sold,

Liability

Owners of a company benefit from limited liability. This is because the company has its own legal personality and becomes its own legal entity. Ownership of that legal entity is divided into shares, with each shareholder purchasing shares in the company and, as a result, investing in the company. The shareholders and the company are different legal persons. This creates the doctrine of limited liability. Limited liability means that the shareholders' liabilities are limited to what they have invested in a company. Creditors may only seek the company's assets for repayment of a debt and the shareholders' personal assets are protected.

e) Community Interest Company

It is a company limited by shares made for a social enterprise and that uses their assets and profits for the benefit of a specific community. Fairly easy to set up and it has the benefits of flexibility given by the company form. CICs have assets, grants, income and contracts, so they will continue trading independently of the funding or grants given. The surplus made is supposed to be reinvested to continue to benefit the community. A portion of it can be used for remuneration.

II. **Corporate Legal documents for certain Corporate Structures**

A. Sole Trader

You should choose a name for your business, either your own name or name that you make up. Registration of the chosen name with the Companies House is not a requirement. The trading name should (i) not be offensive; (ii) not include 'limited', 'Ltd.', 'limited liability partnership', 'LLP', 'public limited company' or 'plc'; and (iii) not be confusingly similar to an existing company's name.

Since you are the sole owner of your business, you don't need to have a written agreement with anyone else about how to run the business. Further, you also don't have to file any paperwork with the Companies House other than the name of the business.

B. General Partnership

Partnership law stipulates certain terms and conditions concerning the governance of a general partnership and hence a bespoke written partnership agreement with your fellow partners is a good idea. However, a general partnership does not have to register with the Companies House, and the partnership agreement is a private document that does not need to be publicly filed.

C. Limited Liability Partnership

A limited liability agreement or partnership agreement is not a legal requirement, but we recommend having one in place. Generally, all LLP members will have equal rights, responsibilities, and share of profits. However, the flexibility of an LLP structure allows members to allot different rights, duties, and proportions of profits in any way they wish. An LLP agreement should be drawn up to stipulate the specifics of each member's rights if they will be anything other than equal.

LLP members must register with HMRC for Self-Assessment and pay Income Tax on any profits they make. They are each responsible for completing and filing their own tax returns, and paying their tax on time. Limited liability partnerships are not liable for Corporation Tax.

D. Private company limited by shares

Companies must be registered with Companies House and the company should have a unique name to get approval from the Companies House. A very important governing document called the articles of association must be adopted during the company's incorporation process, which essentially outlines the rules and regulations of the company and its members and officers.

- A Memorandum of Association, which explains the company's name, location and function and includes your objects and liabilities.
- Articles of Association, which describe how it will be run.

- Form IN01 or the Statement of the First Directors, Secretary and Registered Office, which enumerate where the company's registered office is and provide details of directors and their respective addresses.

E. Community Interest Company (CIC)

To set up as a CIC, you will have to register online with the Companies House or apply by post, similar to registering as a private company limited by shares with the same incorporation documents. A "community interest statement" will be asked from you, which explains what your business plans to do for the benefit of the community. You will also have to provide an "asset lock," a legal promise, which states that the company's assets will only be used for a community benefit. After approval from the CIC Regulator, your company will be ready to operate.