

Total Back Office Solutions Ltd

Legal Structures:the basics

Table of contents

Legal structures: the basics	2
Introduction	2
Self-employment	2
Sole trader	3
Partnership	4
Limited liability partnership (LLP)	5
Limited liability companies	6
Franchises	7
Social enterprises	8
Overview of legal structures	8
Here's how I chose the right legal structure for my business	9
Helplines	10
Related guides on businesslink.gov.uk	11
Related web sites you might find useful	11

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Subjects covered in this guide

[Introduction](#)

[Self-employment](#)

[Sole trader](#)

[Partnership](#)

[Limited liability partnership \(LLP\)](#)

[Limited liability companies](#)

[Franchises](#)

[Social enterprises](#)

[Overview of legal structures](#)

[Here's how I chose the right legal structure for my business](#)

[Helplines](#)

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You can find this guide by navigating to:

Home > Taxes, returns & payroll > Choosing and setting up a legal structure > Legal structures: the basics

Introduction

To put your business on a proper footing with HM Revenue & Customs (HMRC) and other authorities, you need to make sure that it has the right legal structure. It's worth thinking carefully about which structure best suits the way that you do business, as this will affect:

- the tax and National Insurance that you pay
- the records and accounts that you have to keep
- your financial liability if the business runs into trouble
- the ways your business can raise money
- the way management decisions are made about the business

There are several structures to choose from, depending on your situation. This guide will help you understand the differences between them.

If you are not sure which legal structure would best suit your business, it's a good idea to get advice from an accountant or solicitor.

Self-employment

To be a sole trader, a partner, or a member of a limited liability partnership as an individual rather than a company, you must be self-employed - and registered as such with HM Revenue & Customs (HMRC). This does not mean that you can't also do other work as an employee, but the work you do for your own business must be done on a self-employed basis.

You can [download and complete form CWF1 to register as self-employed from the HMRC website \(PDF\)](#) - [Opens in a new window](#).

If you are not sure whether this work counts as self-employment, ask yourself these questions:

- Do you present your clients with invoices for the work that you do for them?
- Do you carry out work for a number of clients?
- Are you responsible for the losses of your business as well as taking the profits?
- Can you hire other people on your own terms to do the work that you've taken on?
- Do you have control over what work has to be done, how the work has to be done and the time and place where the work has to be done?
- Have you invested your own money in your business or partnership?
- Do you provide any major items of equipment which are a fundamental requirement of the work you carry out?
- Do you have to correct unsatisfactory work in your own time and at your own expense?

If you can answer "yes" to most of these questions then you are probably self-employed already, and should let HMRC know this immediately if you have not already done so. You may be fined £100 if you fail to register within three months of becoming self-employed. There is no fee for registration.

For a checklist of all the steps you need to

take to become self-employed, see our guide on how to [set up and register as self-employed](#) which provides information on all the steps you'll need to take.

If you answer "no" to most of the questions above, you will normally be an employee.

[Use our interactive tool to find out which legal structure is right for your business.](#)

Sole trader

Being a sole trader is the simplest way to run a business: it does not involve paying any registration fees, keeping records and accounts is straightforward, and you get to keep all the profits. However, you are personally liable for any debts that your business runs up, which make this a risky option for businesses that need a lot of investment.

Set-up

- You need to register as self-employed - see the page in this guide on [self-employment](#).

Management and raising finance

- You make all the decisions on how to manage your business.
- You raise money for the business out of your own assets and/or with loans from banks or other lenders.

Records and accounts

- You have to make an annual self assessment tax return to HM Revenue & Customs.
- You must also keep records showing your business income and expenses.

Profits

- Any profits go to you.

Tax and National Insurance

- As you are self-employed, your profits are taxed as income.
- You also need to pay fixed-rate Class 2 and 4 National Insurance contributions on your profits.

Liability

- As a sole trader, you are personally responsible for any debts run up by your business. This means your home or other assets may be at risk if your business runs into trouble.

[Use our interactive tool to find out which legal structure is right for your business.](#)

Partnership

In a partnership, two or more people share the risks, costs and responsibilities of being in business. Each partner is self-employed and takes a share of the profits. Usually, each partner shares in the decision-making and is personally responsible for any debts that the business runs up.

Unlike a limited company, a partnership has no legal existence distinct from the partners themselves. If one of the partners resigns, dies or goes bankrupt, the partnership must be dissolved - although the business can still continue.

A partnership is a relatively **simple and flexible** way for two or more people to own and run a business together. However, partners do not enjoy any protection if the

business fails.

Set-up

- Each partner needs to register as self-employed - see the page in this guide on [self-employment](#).
- It's a good idea to draw up a written agreement between the partners. For further advice, consult an accountant or solicitor.

Management and raising finance

- Partners themselves usually manage the business, though they can delegate responsibilities to employees.
- Partners raise money for the business out of their own assets, and/or with loans.
- It's possible to have 'sleeping' partners who contribute money to the business but are not involved in running it.

Records and accounts

- The partnership itself and each individual partner must make annual self-assessment returns to HM Revenue & Customs (HMRC).
- The partnership must keep records showing business income and expenses.

Profits

- Each partner takes a share of the profits.

Tax and National Insurance

- As partners are self-employed, they are taxed on their share of the profits.
- Each partner also needs to pay

Class 2 and 4 National Insurance contributions.

Liability

- Creditors can claim a partner's personal assets to pay off any debts - even those debts caused by other partners.
- In England, Wales and Northern Ireland, partners are jointly liable for debts owed by the partnership and so are equally responsible for paying off the whole debt. They are not severally liable, which would mean each partner is responsible for paying off the entire debt. Partners in Scotland are both jointly and severally liable.

However, if a partner leaves the partnership, the remaining partners may be liable for the entire debt of the partnership. Also, a creditor may choose to pursue any of the partners for the full debt owed in the case of insolvency.

Limited liability partnership (LLP)

An LLP is similar to an ordinary partnership - in that a number of individuals or limited companies share in the risks, costs, responsibilities and profits of the business.

The difference is that liability is limited to the amount of money they have invested in the business and to any personal guarantees they have given to raise finance. This means that members have some protection if the business runs into trouble.

Set-up

- Each member needs to register as self-employed - see the page in this

guide on [self-employment](#).

- There is no restriction on the number of members, but at least two must be **designated members** - the law places extra responsibilities on them. [Read the list of extra legal responsibilities placed on designated members on the Companies House website - Opens in a new window](#).
- If the LLP reduces in number and there are fewer than two designated members then every member is deemed to be a designated member.
- LLPs must register at Companies House.
- It's a good idea to draw up a written agreement between the members. For further advice, consult an accountant or solicitor.

Management and raising finance

- Usually the members manage the business, but can delegate responsibilities to employees.
- Members raise money out of their own assets and/or with loans.

Records and accounts

- The LLP itself and each individual member must make annual self-assessment returns to HM Revenue & Customs (HMRC).
- All LLPs must file accounts with Companies House.
- An annual reminder letter will be sent to the LLP a few weeks before the due date requesting they download the form from the Companies House website. It needs to be completed and returned to Companies House with the appropriate fee. [Download a copy of the form LLP363 from the Companies House website](#)

[\(PDF\) - Opens in a new window.](#)

Profits

- Each member takes an equal share of the profits, unless the members agreement specifies otherwise.

Tax and National Insurance

- Members of a partnership pay tax and National Insurance contributions (NICs) on their share of the profits.
- The profits of a member of an LLP are taxable as profits of a trade, profession or vocation and members remain self-employed and subject to Class 2 and 4 NICs.

[Find further information for businesses in Northern Ireland on the Department of Enterprise, Trade and Investment Companies Registry website - Opens in a new window.](#)

Limited liability companies

Limited companies exist in their own right. This means the company's finances are separate from the personal finances of their owners.

Shareholders may be individuals or other companies. They are not responsible for the company's debts unless they have given guarantees (of a bank loan, for example). However, they may lose the money they have invested in the company if it fails.

The Companies Act 2006 makes a number of changes that will affect directors and shareholders of limited companies. You can [read about the Companies Act 2006 on the Department for Business, Enterprise and Regulatory Reform \(BERR\) website -](#)

[Opens in a new window.](#)

Main types

- **Private limited companies** can have one or more members, eg shareholders. They cannot offer shares to the public.
- **Public limited companies** (plcs) must have at least two shareholders and must have issued shares to the public to a value of at least £50,000 before it can trade. [View the guide to company formation on the Companies House website - Opens in a new window.](#)
- **Private unlimited companies** - these are rare and usually created for specific reasons. It is recommended you take legal advice before creating one.

Set-up

- Must be registered (incorporated) at Companies House.
- Must have at least one director (two if it's a plc) who may also be shareholders. Directors must be at least 16 years of age.
- Private companies are not obliged to appoint a company secretary but if one is appointed this must be notified to Companies House. Public limited companies must have a qualified company secretary.

Management and raising finance

- A director or board of directors make the management decisions.
- Finance comes from shareholders, loans and retained profits.
- Public limited companies can raise money by selling shares on the stock market, but private limited companies cannot.

Records and accounts

- Accounts must be filed with Companies House before the time allowed for filing those accounts to avoid a late filing penalty.
- Accounts must be audited each year unless the company is exempt.
- When you file your Annual Return for the first time a letter will be issued to the Registered Office containing the company's authentication code and instructions for use of Companies House web filing services. Please follow the instructions in the letter.

You can [find out about company accounts on the Companies House website - Opens in a new window.](#)

Directors are responsible for notifying Companies House of changes in the structure and management of the business.

Profits

- Profits are usually distributed to shareholders in the form of dividends, apart from profits retained in the business as working capital.

Tax and National Insurance

- If a company has any taxable income or profits, it must tell HM Revenue & Customs (HMRC) that it exists and is liable to corporation tax.
- Companies liable to corporation tax must make an annual return to HMRC.
- Company directors are employees of the company and must pay both income tax and Class 1 National Insurance contributions on their salaries.

Liability

- Shareholders are not personally responsible for the company's debts, but directors may be asked to give personal guarantees of loans to the company.

[Find further advice and guidance for businesses in Northern Ireland on the Department of Enterprise, Trade and Investment Companies Registry website - Opens in a new window.](#)

Franchises

Buying a franchise is a way of taking advantage of the success of an established business. As the '**franchisee**', you buy a licence to use the name, products, services and management support systems of the 'franchiser' company. This licence normally covers a particular geographical area and runs for a limited time, after which it should be renewable as long as you meet the terms of the franchise agreement.

See our guide on how to [buy a franchise](#).

The way you pay for the franchise may be through an initial fee, ongoing management fees, a percentage of your turnover, purchases of goods from the franchiser, or a combination of these.

A franchise business can take different **legal forms** - most are sole traders, partnerships or limited companies. Whatever the structure, the franchisee's freedom to manage the business is limited by the terms of the franchise agreement.

Set-up

- This depends on the business structure that the franchisee chooses for their business - usually a sole trader, partnership or limited company.

Management and raising finance

- Franchise agreements usually set out how the franchised business should be run, although they may allow some flexibility. Franchisers usually provide management help and training to franchisees.
- Normally the franchisee must find the money needed to start up the business, but franchisers may sometimes loan some of this.

Records and accounts

- These depend on the business structure that the franchisee chooses for their business. As well as the usual legal requirements, franchisers often expect franchisees to show them detailed financial records.

Profits

- Franchisees often pay a percentage of their turnover to the franchiser, which brings down the overall profits.

Tax and National Insurance

- These depend on the business structure that the franchisee chooses for their business.

Liability

- This depends on the business structure that the franchisee chooses for their business.

A social enterprise is a business with primarily social objectives. Any profits are largely reinvested in the business or in the community, rather than given to shareholders and owners.

There are many different types of social enterprises, including community development trusts, housing associations, worker-owned co-operatives and leisure centres.

Social enterprises may take a number of different **business structures** - the most common are companies limited by guarantee, companies limited by shares, and industrial and provident societies.

See our guide on how to [set up a social enterprise](#).

Overview of legal structures

Sole trader

The advantages of being a sole trader include independence, ease of set up and running, and the fact that all the profits go to you.

The disadvantages include a lack of support, unlimited liability and the fact that you are personally responsible for any debts run up by your business.

Partnership

The advantages of being in a partnership include its ease of set up and running, and the range of skills and experience that the partners can bring to the business.

On the other hand, problems can occur when there are disagreements between

Social enterprises

partners. There is unlimited liability and, as a partner, you are personally responsible for any debts that the business runs up.

Limited liability partnership (LLP)

LLPs retain the flexibility of a partnership and your personal liability is limited. There is no restriction on the number of members, but at least two must be 'designated members' - the law places extra responsibilities on them.

The formation of an LLP is more complex and costly than that of a partnership and problems can occur when there are disagreements between the members. If the number of partners is reduced, and there are fewer than two designated members, then every member is deemed to be a designated member.

Limited liability company

In a limited liability company your personal financial risk will be restricted to how much you invest in the business and any guarantees you have given in order to obtain financing.

However, you should remember that this type of company also brings a range of extra legal duties, including the maintenance of the company's public records, eg for the purpose of the filing of accounts.

Franchise

The major advantage of a franchise is that it takes advantage of the success of an established business and support networks.

However, your freedom to manage the business is limited by the terms of the franchise agreement. Also franchisees often

pay a share of their turnover to the franchiser, which reduces overall profits.

Social enterprises

Social enterprises are businesses that trade for a social purpose and represent a diverse and growing range of business activity across the UK. [Find out about social enterprises on the Social Enterprise Coalition website - Opens in a new window.](#)

[Use our interactive tool to find out which legal structure is right for your business.](#)

Here's how I chose the right legal structure for my business

John Kerr

Kerr Print and Stationery

John's top tips:

- "Take professional advice on the best way to set up your business - don't assume that you need to form a company."
- "Think about how your business relationship will work in practice before you go into partnership."
- "Consider if your structure is still the right one when circumstances change - you don't have to stick with the structure you chose when you started up."

After 10 years as the general manager of an office supplies company, in 2001 John Kerr decided that he wanted to run his own business. Initially, John went into

partnership with a former colleague. After a series of disagreements they agreed to go their separate ways, and John has a new business partner.

What I did

Talk to a solicitor

"Originally I'd planned to take on my colleague as an employee. But he wanted to share in the management of the business, which seemed fair enough, so we talked to a solicitor about the choices.

"Setting up a partnership was the simplest option, and would avoid the extra costs of setting up and administering a company. The solicitor pointed out that we would both be personally liable for any business debts, but as we weren't planning to borrow this wasn't a big issue for us."

Start the business

"The solicitor said that we needed a partnership agreement, and helped us draw one up. Preparing the agreement was a chance for us both to think about how we wanted to run the business and what our responsibilities would be.

"Apart from that, the official side of starting the business was very straightforward. We each registered as self-employed and for VAT with HM Revenue & Customs and told them that we were going into partnership. At the same time, we set up a computerised accounting system and lined up an accountant to handle our tax returns. With our systems set up, we were ready to get on with building the business."

Reorganise the business

"Unfortunately, we soon realised that we didn't work together well. We each had our own ideas on what we should be doing, and it wasn't helping the business at all. A few months after we started, my partner left the business.

"As it happened, there was someone else I wanted to bring into the business anyway. Reorganising the partnership was straightforward, but I did check with the solicitor and tell the accountant. It seems to have worked out well enough. Turnover of our business has more than doubled in the last three years, so we must be doing something right!"

What I'd do differently

Think through the working relationship

"When we set up the original partnership, the solicitor made a point of talking about the problems we could face if we disagreed on how to run the business. The partnership agreement was supposed to be a way of overcoming that risk, but we just didn't put enough thought into it. We were excited about starting our new business, not thinking about things going wrong. With the benefit of hindsight, I can see that it was always going to be difficult for me to adjust to sharing decisions with someone who used to work for me."

[Read more case studies that describe first-hand how people tackle real-life challenges and opportunities](#)

Helplines

HMRC Newly Self-Employed Helpline

0845 915 4515

Companies House Contact Centre

0303 1234 500

British Franchise Association Enquiry Line

01865 379 892

Social Enterprise Coalition Enquiry Line

020 7793 2324

Related guides on
businesslink.gov.uk

[Use our interactive tool to find out which legal structure is right for your business](#) | [Manage your personal list of starting-up tasks with our Business start-up organiser](#) | [Use our interactive tool to get a beginner's guide to tax and accounts rules](#) | [Choose the right name for your business](#) | [Set up and register a limited company \(private or public\)](#) | [Set up and register a limited liability partnership \(LLP\)](#) | [Set up and register a partnership](#) | [Set up and register as self-employed](#) | [Tax returns for the self-employed](#) | [Change a partnership](#) | [Tax returns for partners and partnerships](#) | [Companies House annual return](#) | [File accounts at Companies House](#) | [Buy an existing business](#) | [Buy a franchise](#) | [Set up a social enterprise](#) | [Here's how I changed the legal structure of my business](#) | [Here's how I decided I was ready to start up my business](#) | [Here's how I made a joint venture successful](#) |

Related web sites you might find useful

[Starting up in business advice from HMRC](#) - Opens in a new window

[Find a solicitor with the Law Society](#) - Opens in a new window

[Find an accountant with the Institute of Chartered Accountants in England and Wales](#) - Opens in a new window

[Download the guide to employment status for tax and National Insurance contributions from HMRC \(PDF, 60K\)](#) - Opens in a new window

[Use the HMRC Employment Status Indicator to ensure you are correctly classified as self-employed](#) - Opens in a new window

[Download form CWF1 to register as self-employed from HMRC \(PDF, 61K\)](#) - Opens in a new window

[Self Assessment for partnerships guidance from HMRC](#) - Opens in a new window

[Limited liability partnerships guidance from Companies House](#) - Opens in a new window

[Companies Act 2006 guidance from the Department for Business, Enterprise and Regulatory Reform](#) - Opens in a new window

[Company formation guidance from Companies House](#) - Opens in a new window

[Corporation tax information from HMRC](#) -

Opens in a new window

Company accounts advice from Companies House - Opens in a new window

Franchising information from the British Franchise Association - Opens in a new window

Social enterprises information from the Social Enterprise Coalition - Opens in a new window

Legal structures advice from Employee Ownership Options - Opens in a new window

Registering as a charity instructions from the Charity Commission - Opens in a new window