ACTIVE PRACTICE UPDATES
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Morris Owen

chartered accountants, business advisers and more...

HOW SHOULD YOU STRUCTURE YOUR BUSINESS?

Business structures are essential for tax purposes.

If you're looking to join the 4.3 million people in the UK who made the jump into self-employment, you might be wondering how to start your new business.

Assuming you've weighed up the pros and cons involved and decided launching a startup is right for you, one of the first things to consider is how will you pay tax?

This requires you to choose a structure for your new business. The three most popular options are sole proprietorship, general partnership or limited company.

Last year, operating as a sole trader was the most common structure as around 3.2m sole traders accounted for 56% of the UK's entire private-sector business population.

By comparison, there were 2m actively-trading companies and 384,000 general partnerships, making up 37% and 7% of the business population, respectively. You can also be a limited liability partnership.

The vast majority of those sole proprietors are genuine one-man bands; that's to say they don't have any employees (in an official capacity, at least).

There's no rhyme or reason for going it alone and it's worth being aware of the key options on the table when you start a business. You can also change your business's structure whenever you like, although that can prove costly.

SOLE PROPRIETORSHIPS

Being a sole trader means there's no legal distinction between your business and your own personal finances.

You will be solely responsible for any losses the business makes during the tax year, which currently runs from 6 April to 5 April the following year, as well as any of the business's bills.

It will also be your responsibility to keep accurate records of any income and expenses from the tax year. This will be of paramount importance when Making Tax Digital for income tax comes in from April 2024.

In terms of your tax liabilities, your business profits will be assessed for income tax where not covered by the personal allowance (£12,570 in 2021/22).

You currently need to file a self-assessment tax return relating to the previous tax year on or before midnight on 31 January.

Any amount of your business turnover, minus any expenses, that exceeds the personal allowance up to £50,270 will be charged income tax at the basic rate of 20%.

The slice of business profits worth £50,271 up to £150,000 will be taxed at 40%. Any excess profits above £150,000 will be taxed at the additional rate of 45%.

You will also need to pay National Insurance contributions (NICs) above certain thresholds. Class 2 NICs are currently fixed at £3.05 a week, unless the profits are less than £6,515. Class 4 NICs are charged at 9% of profits between £9,569 and £50,270 and 2% on profits above £50,270.

GENERAL PARTNERSHIPS

Ordinary business partnerships share many things in common with sole proprietorships. They're both usually registered as self-employed and liable for income tax and NICs at the same rates and thresholds.

The key difference is that two or more people manage and operate the partnership, rather than the one individual in a sole proprietorship.

Partners split any profit in a pre-agreed ratio, and the same ratio determines responsibility for any losses the partnership makes.

Business partners' tax reporting obligations are slightly different to sole traders, however. When you register as an ordinary partnership, you have to 'nominate' a partner to be responsible for submission of the partnership tax return.

This SA800 form simply asks for details of the partnership's income in a tax year. That should include income from trades and professions, interest or alternative finance receipts from banks, building societies or deposit takers, all of which should all be reported on or before midnight on 31 January following the end of the tax year.

After the profits have been allocated, each partner needs to file their own personal tax return through self-assessment, reporting their profit share.

LIMITED LIABILITY PARTNERSHIPS

Limited liability partnerships (LLPs) are similar to ordinary partnerships from a tax perspective, but similar to companies from a legal perspective since the partners' liability is limited to the amount of money they invest in the business.

You can incorporate an LLP to run a business with two or more members. A member can be an individual or a company; the latter's known as a 'corporate member'.

An LLP agreement will set out the members' responsibilities and share of the profits. Exactly like ordinary partnerships, each member pays income tax and NICs on their share of the profits, but they are not personally liable for any debts the LLP incurs.

Like a limited company, an LLP must be registered at Companies House and with HMRC, while you will also have to arrange for the annual accounts to be prepared and filed.

INCORPORATIONS

If you choose to incorporate your business, you will probably go down the limited company route. Broadly speaking, this is a legal structure for a business in which the liability of each shareholder is limited to their own investment.

Limited companies are governed by rules and regulations in the Companies Act (2006), one of which means you must register with Companies House. Private-sector companies are usually limited by shares which are distributed among its shareholders and are not traded on public stock markets.

Companies pay corporation tax, currently at 19%, on any taxable profit they makes during their accounting periods. Depending on how you decide to pay yourself, taxes on income, dividends and NICs can all come into play for you personally.

While the prospect of having limited liability will seem attractive, you will have more responsibilities than if you were to operate as a sole trader.

UMBRELLA COMPANIES

If you're on a short-term contract or just trying out the world of freelancing, working through an umbrella company might be a suitable option.

An umbrella company sits between you (the contractor) and your end-clients, or agency if there's one involved. The umbrella company will employ you and be responsible for handling all of your employment taxes.

If you're a contractor or freelancer, this offers peace of mind as the umbrella company pays your taxes and chases late payments from clients. It can also offer valuable benefits like sick pay and annual leave.

You simply do the work, fill in a timesheet, your end-client authorises it and invoices the umbrella company, who then deducts your taxes and its fee before paying you.

WHAT'S THE BEST OPTION FOR YOU?

Being a sole trader offers the most control over your business, and is both easy and cost-effective to set up. You will, however, be liable for any debts it racks up.

What can be said about sole traders also applies to partnerships, although with more than one person calling the shots in a partnership comes the potential for disagreements.

LLPs exhibit elements of a being in a business partnership and running a limited company. If you go down this route, you must start trading within a year of registering your LLP or face being struck off.

Limited companies offer you less personal financial exposure with the protection of limited liability and the flexibility to remunerate yourself in tax efficient ways. However, there can be significant set-up costs and your annual accounts and financial reports will be in the public domain.

Umbrella companies suit freelancers and contractors, and can ensure you stay on the right side of the off-payroll working rules more commonly known as IR35.

Get in touch to discuss your options.