

## Should you form a Limited Company?

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When establishing a business it is important to consider which is the best trading entity for you:

- Sole trader - an individual
- Partnership - two or more individuals
- Limited company

We are often asked, 'Should I form a limited company?' The answer depends on the business, its expected rate of growth, and the degree of commercial risk.

In the early years of a business, the privacy of operating as a sole trader or partnership may prove more beneficial. There can also be tax advantages in starting as a sole trader or partnership and then incorporating after a few years.

### **Advantages of incorporation**

Incorporation normally provides limited liability. If a shareholder has paid fully for his or her shares, he or she cannot normally be required to invest any more in the company. However, banks often require personal guarantees from the directors for borrowings of the company. Even so, the advantages of limited liability will generally apply in respect of liabilities to other creditors.

- A company enjoys legal continuity - it can own property, sue, and be sued.
- Effective ownership of the business may be readily transferred, subject to the provisions of the Articles of Association.
- Normally a bank can take extra security by means of a 'floating charge' over the assets of the company, and this will increase the amount that can be borrowed against the assets of the business.
- Companies can re-invest profits after an effective tax charge of no more than 20% (if profits are below £300,000), compared with 40% for higher-rate tax paying sole traders and partners.
- Corporate status is sometimes thought to add to the credibility or commercial respectability of the business.
- A company can establish an approved pension scheme, which may provide greater benefits than self-employed schemes.
- Employees may, with adequate safeguards, be offered an opportunity to acquire an interest in the business, reflecting their position in the company.
- The liability of executors acting for deceased shareholders, or of trustees, is clearly defined.

### **Disadvantages of incorporation**

- Normally when you form a company you incur legal and administrative costs. The 1985 Companies Act requires that proper books and records be maintained. Annual accounts must comply with the requirements of the Act. In most cases a statutory audit is not required for companies with an annual turnover of £1 million or less. The statutory audit involves work over and above that which is normally carried out for a sole trader or partnership.
- A company's accounts must be filed on public view with the Registrar of Companies. An annual return must also be submitted to the Registrar together with a filing fee of £15.
- The company will be taxed on actual profits in each accounting period, as opposed to the current year basis for sole traders and partnerships.

- Cash withdrawn from a company normally gives rise to tax liabilities, whereas unincorporated businesses can generally introduce and withdraw cash without tax implications.
- Remuneration for directors is subject to *both* employees' and employers' national insurance liabilities - currently up to 21.9%. For example, on a remuneration of £12,000 there is a NI liability of £1,637.
- Tax on directors' remuneration paid monthly is payable on the 19th of the following month through the PAYE system, and corporation tax is payable nine months after the end of a company's accounting period. For a sole trader or partnership, tax is generally paid by instalments on the 31 January in the tax year and the 31 July following the tax year. For example, tax for 2001/02 is payable: first payment on account on 31 January 2002, second payment on account on 31 July 2002, with any final balance due on 31 January 2003. The 'credit period' depends upon the choice of accounting date, and you should contact us for further advice on this.
- Companies pay tax on capital gains at their corporation tax rate (maximum 20% for profits up to £300,000). In a company, a capital gain is reflected in the value of its shares, and if these are sold a 'double charge' to capital gains tax can arise. This may be avoided if assets that are likely to increase in value are owned either outside the company or within a self-administered pension scheme.
- An individual has greater flexibility in dealing with trading losses.
- A company director is more at risk of criminal or civil penalty proceedings, e.g. for late filing of accounts or for breaking the insolvency rules.