

FARRER & Co

A basic guide to the legal process

Choosing a business vehicle



Introduction

When starting a new business venture, one of the earliest decisions to make is what legal form the business should take. Under English law there are a number of structures available, each with different characteristics. In this basic guide we consider the four main structures used in the UK, the key features of each and some relevant considerations when choosing between them.

“

A broad range of knowledge and strength across the board.”

- Corporate M&A, Chambers and Partners UK 2021

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1. Vehicles

The four main UK business vehicles are:



Sole Trader



General Partnership



Limited Company



Limited Liability Partnership (LLP)

2. Key considerations

When choosing a structure, depending on your intended ownership, trading plans and funding requirements, you may wish to consider:

Legal personality

Is the entity a legally-recognised person, distinct from its owners and managers?

Government flexibility

How easy is administration and how prescriptive is the governing statute?

Limited liability

Can the business owners limit their losses?

Disclosure

What information about the business will need to be made public?

Financial entitlements

How do the owners extract profits?

Tax treatment

Does the business itself have to pay tax on its profits?

“Investibility”

How easy or appealing is it for third parties to invest in the business?

International recognition

Is the vehicle recognised and treated consistently in other jurisdictions where you might do business?

2.1 Sole Trader

This is the simplest form of business and involves an individual conducting business on their own account – either in their own name or using a trading name.

There are no inherent expenses to setting up a business as a sole trader, no filing requirements, no fixed management structure, and the sole trader has total control over how the business operates (within the confines of general contract law).

A large proportion of UK small businesses operate as sole traders.

Legal personality and structure

Sole trading is by far the most straightforward medium through which to operate a business, as legally there is no difference between the individual and the business itself.

There is also no specific governing legislation relating to the formation of sole trader businesses.

Governance flexibility

Subject to the general commercial, tax, and contract laws, sole traders have complete flexibility to conduct their business affairs as they wish.

Limited liability

Because there is no separation between a sole trader and their business, sole traders do not have limited liability; the individual operating the business has unlimited liability and all of their assets, whether related to the business or not, are at risk if the business fails or cannot pay its debts.

Disclosure

Sole traders are not obliged to make any of their constitution or finances public. If they use a trading name, they must disclose the name of the contracting party.

Financial entitlements

A sole trader is entitled to all the profits or his or her business and has full discretion as to how these may be distributed.

Tax treatment

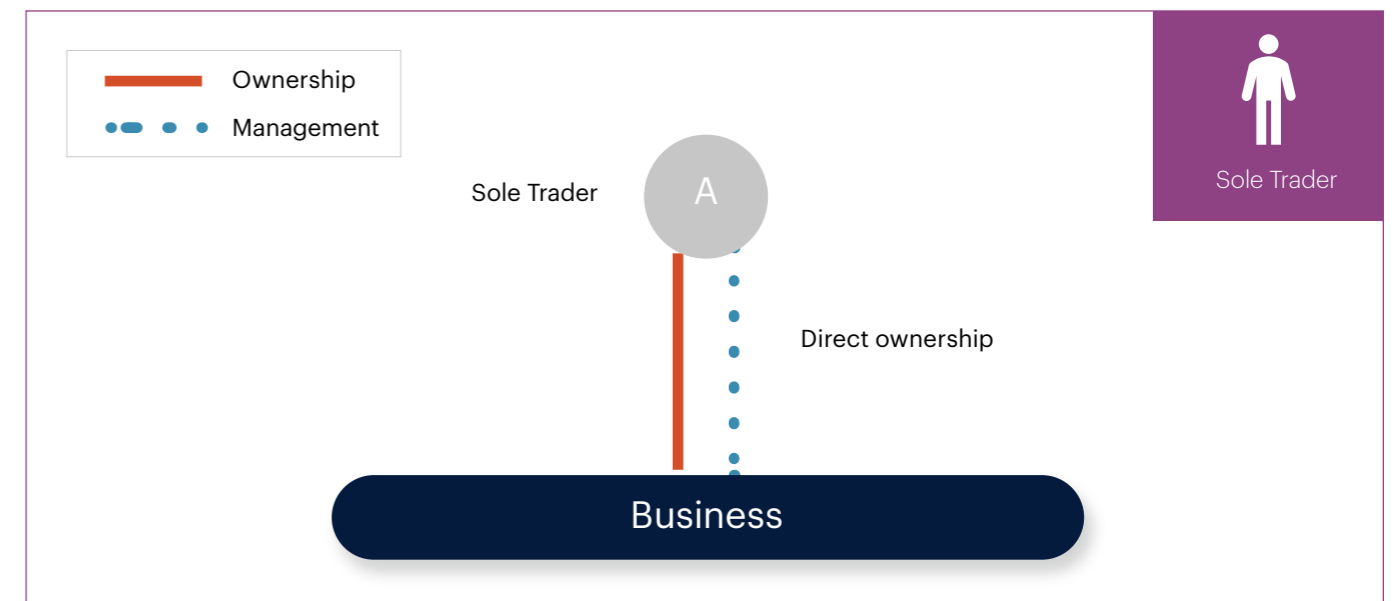
A sole trader is subject to personal tax filing requirements and the business does not pay additional taxes on its profits.

“Investibility”

It is not possible to make an equity investment in a sole tradership (without it becoming a partnership or joint venture). Sole traders can borrow money to fund their business but there is no option of raising capital through issuing shares or the creation of charges.

International

Sole traders are generally recognised internationally in the sense that all jurisdictions permit personal contractual relations. International operations will be subject to the relevant laws governing sole trading in those jurisdictions.



2.2 General Partnership

A general partnership is formed when two or more people enter into business together. They are a well-known and long-established form of business with a body of supporting case law that has developed over more than a century. Until the advent of the LLP (see 2.4 below) they were the preferred vehicle for most professional firms in the UK and remain very common.

Legal personality and structure

A general partnership is not a separate entity but merely refers to “the relation which subsists between persons carrying on a business in common with a view of profit” (the Partnership Act 1890.)

A partnership trading name such as “Smith & Co” simply operates as shorthand for “all of the partners of Smith & Co from time to time” and technically a new partnership is formed each time there is a change to its membership.

Every partner of a partnership is, by default, an agent of every other partner, meaning they all have the ability to contractually bind the entire firm.

Governance flexibility

Partnerships are very flexible vehicles, with partners being both owners and managers of the business. The Partnership Act provides a basic governance framework and default rules that will apply in the absence of provision to the contrary. However, most default rules can be disapplied and the partners of the firm have almost complete flexibility to arrange their affairs as they see fit.

Partnerships will generally be governed by a Partnership Deed (a formal document setting out how business decisions are made, how partners are admitted or removed, how capital is contributed and how partners share profits).

Limited liability

Similarly to sole traderships, since a general partnership does not have its own legal personality, the partners are jointly liable for the partnership’s debts and obligations, whilst also being jointly and severally liable for any wrongdoing committed by their fellow partners.

Lord Lindley famously declared “every member of an ordinary partnership is liable to the utmost farthing of his property for the debts and engagements of the firm”. Because of the capacity of partners to bind each other and the potential for unlimited liability, the law implies a “duty of good faith” requiring the very highest standards of openness and honesty between partners in relation to their dealings.

Disclosure

Very few financial disclosure requirements apply to partnerships as they are not obliged to file their accounts nor to make their financial records available to anyone other than the partners.

Partnerships must make public the name of each partner and a principal office in the UK where documents may be served. This information must be disclosed on business letters, orders for goods, invoices and other formal business documents. Large partnerships, with more than 20 partners, may instead publish a list of partners at their principal place of business and state on their paperwork that this list is available for inspection.

Financial entitlements

Partnerships are entitled to divide their profits, whether capital or income, as they see fit (the Partnership Deed will usually prescribe a mechanism for this). Alternatively, by default the Partnership Act provides that profits will be divided equally.

Tax treatment

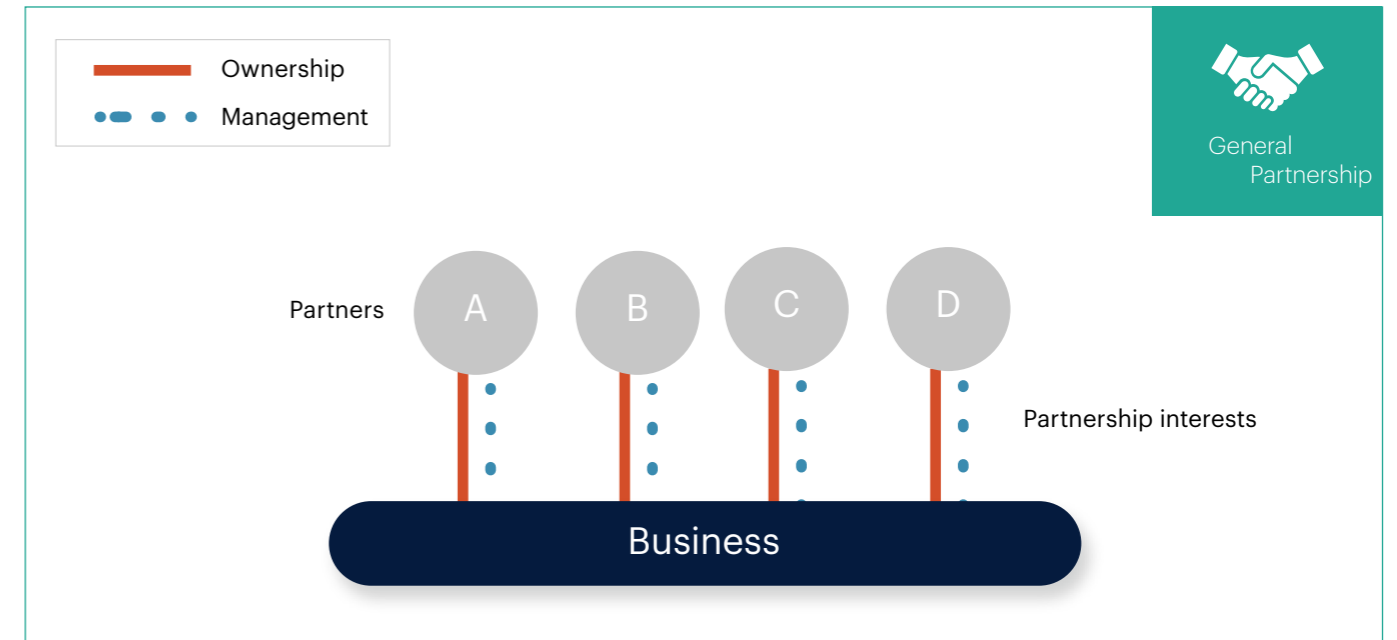
For tax purposes, a partnership is treated as “transparent”, meaning that the business itself is not viewed as a taxable entity. Partners are treated as having earned profits directly and are taxed accordingly (whether as income or capital gains) regardless of whether the profits are actually distributed out of the business. For this reason, it is generally tax-inefficient to withhold profits within a partnership.

“Investibility”

Equity investment into a partnership by non-partners is not generally possible (although it is possible to introduce “sleeping partners” who have minimal or only a defined influence over the business.) Capital contributions can be sought from incoming partners and the business can take on third party debt.

International

General partnerships are usually recognised internationally. Their lack of registered presence is occasionally problematic.



2.3 Limited Company

The limited company is by far the best known and most popular corporate entity in the UK.

Limited companies may be:

- private companies limited by shares (“Ltd”);
- private companies limited by guarantee (also “Ltd”); and
- public companies limited by shares (“Plc”).

Companies may also be “unlimited”, but this is not particularly common. We focus in this note on private companies limited by shares.

Legal personality and structure

A company is a body corporate which means that it is a distinct, legally recognised person. Accordingly, a company can own and deal in property, enter into contracts on its own behalf and sue or be sued in its own name.

The main constitutional document of a company is its Articles of Association which will, among many

other matters, set out how the company is run, how decisions are made and how profits are distributed to the shareholders.

Companies may adopt bespoke Articles or the “Model Articles” which are contained within the Companies Act 2006.

In addition to Articles, many private companies will adopt a Shareholders Agreement. Unlike the Articles, this is not a public document and will often be used to supplement the Articles or record personal contractual terms agreed between the shareholders.

Governance flexibility

Ownership and management is held separately by shareholders (members) and directors respectively. The same person may (and frequently does) hold both roles.

The Companies Act is a lengthy and prescriptive piece of legislation that provides a comprehensive statutory framework for all actions that a company may wish to undertake. For this reason, they are less flexible than partnerships or LLPs from an administrative perspective.

Typically, day to day control of a company is vested in its directors but certain major decisions (for example, changing the company's name or the Articles) will require shareholder approval.

Directors and shareholders have separate meetings where votes will take place to decide matters – the notice of meetings, quorum, voting thresholds, deadlock provisions and other administrative points will usually be contained within the Articles and/or any Shareholders Agreement.

Limited liability

A key feature and benefit of the Limited Company is that the liability of its shareholders is limited. A shareholder's liability is generally limited to any (unpaid) nominal value of their shares.

Although directors can on rare occasions be found personally liable, particularly where there is malfeasance, they do not generally have any liability for debts of the business.

Disclosure

The disclosure and general administration requirements for companies are more onerous than for other entities.

A company's Articles and Memorandum are public documents.

A company must file an annual Confirmation Statement (confirming the accuracy of information held by Companies House) and accounts every year.

Certain changes must also be filed as and when they occur to: a company's registered office, directors, share allotments and new class rights, registered charges, certain members' resolutions and "Persons with Significant Control" (PSCs).

A company must also keep certain information internally: a register of shareholders, PSC register, register of directors, directors' service contracts and indemnities, register of secretaries, register of debenture holders, minutes from directors' meetings, minutes of shareholder meetings and copies of shareholder written resolutions.

Financial entitlements

The profits of a company are distributed to shareholders as dividends. Shareholders may also be paid a salary as employees and directors.

A company's profit-sharing arrangements are governed by the rights attaching to different classes of share (a company may have a single or several classes of share in issue).

The paid-up capital for the issued shares in a company must be maintained as a last resort fund available to creditors. There are only limited circumstances in which this capital can be redistributed back to the shareholders.

Tax treatment

A company will pay corporation tax on its profits, but as shareholders also pay dividend or income tax on distributed profits there may be an element of "double taxation". However, companies are not obliged to distribute their profits and so (unlike LLPs and partnerships) it may be tax efficient to retain profits within the business for capital investment purposes.

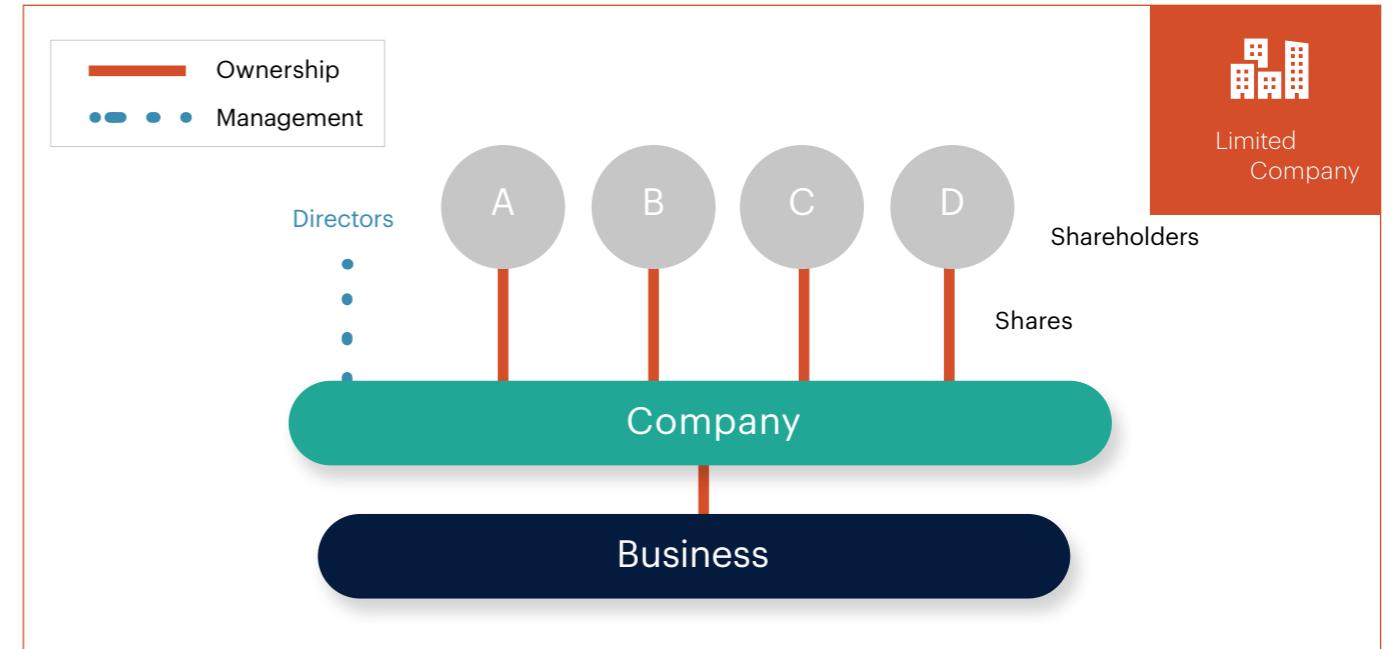
"Investibility"

Companies are well established and globally recognised entities, familiar to most investors. They are supported by a comprehensive statutory framework and protections for shareholders, making equity investment straightforward and appealing.

Companies are also able to borrow money and grant security for debt.

International

The limited company is internationally recognised with few legal or tax uncertainties.



2.4 Limited Liability Partnership (LLP)

LLPs are a comparatively new legal entity (having only been created in 2001). Given the combination of administrative flexibility and limited liability they have now become the chosen vehicle for most professional firms of any size in the UK. The unique combination of legal personality and tax transparency means they are also frequently useful in tax planning structures.

Legal personality and structure

LLPs can be seen as a hybrid between general partnerships and limited companies. An LLP is a body corporate with legal personality separate to its members (often still called "partners" despite the technical difference).

As a body corporate, an LLP can do anything a natural person can, including entering into contracts and holding property.

Governance flexibility

LLP members are both owners and managers of the business. As with general partnerships, members have almost complete flexibility to arrange their affairs as they see fit.

At least two members of the LLP must be "designated members" whose function is similar to that of a company secretary with ultimate responsibility for various Companies House filings, including the filing of annual accounts.

LLPs are usually governed by a Members Agreement or LLP Agreement - a contract between the members and the LLP (which, as a legal person, has its own rights and obligations). It will include many provisions similar to those found in a Partnership Deed. Unlike a company's Articles, a Members Agreement is not a public document.

It is not technically a requirement for an LLP to have a written Members Agreement. However, in the absence of agreed terms various "default rules" will apply. These are unlikely to be appropriate for most businesses and so a written Members Agreement is nearly always recommended.

Limited liability

A key feature and benefit of operating a business through an LLP is that its members have the benefit of limited liability.

The members' liability is generally limited to the assets which they contribute to the LLP (plus any profits which have not yet been distributed).

There remains some academic uncertainty as to the exact extent of protection afforded by an LLP in comparison to a limited company but there is little doubt that it is considerably preferable to the position of a sole trader or general partner.

Disclosure

LLPs are obliged to file at Companies House details of their registered office, the members, an annual Confirmation Statement, annual accounts, mortgages, charges (and any changes to these particulars).

The LLP must also retain internal, inspectable statutory registers of the members, any PSCs and debenture holders.

Unlike companies, the constitutional documents of an LLP are not public documents and, because they do not have share capital, there is no public information as to how (or in what proportions) the members own the LLP.

Financial entitlements

Profits are distributed to members as profit shares which are declared at the end of the financial year. Members will often make drawings on account of profits throughout the year.

The Members Agreement will usually provide a mechanism for allocation and distribution of both capital and income profits.

Note that in addition to its members, an LLP may have employees who receive a salary (although it is not technically possible to be both a member and employee simultaneously).

LLPs have no statutory capital maintenance requirements.

Tax treatment

LLPs are tax transparent. Although a partnership return is filed, members are treated as having earned profits directly as if they were in general partnership. Thus, similarly to a general partnership, profit retention is usually tax-inefficient.

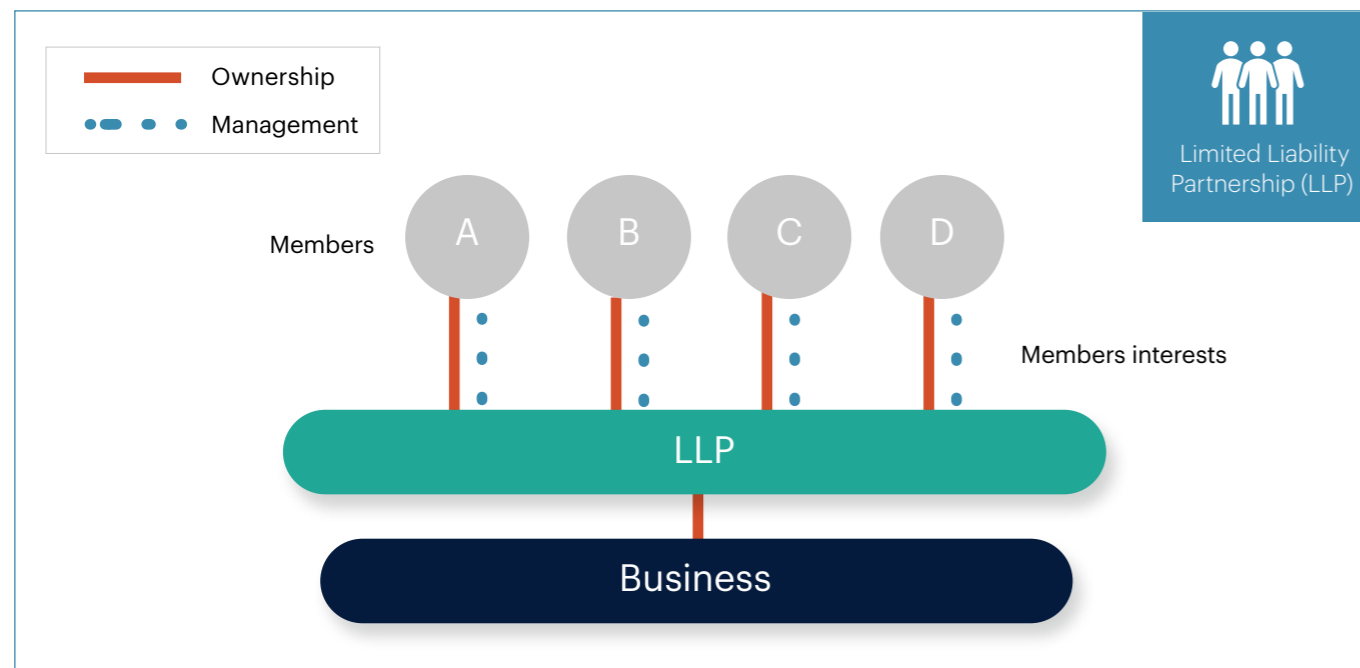
“Investibility”

As corporate entities, it is possible to make equity investments into LLPs. However, it should be acknowledged that the lack of a comprehensive statutory framework or industry standard approach generally makes this a more complicated and uncertain process than for limited companies.

LLPs can, however, borrow money, as well as grant both fixed and floating charges and so debt finance is common.

International

Whilst LLPs are generally and increasingly recognised in other jurisdictions, they do not always have the same degree of recognition as companies. In particular, the willingness of some jurisdictions to recognise tax transparency and the separate legal personality can vary.



5. Summary Table

	Sole Trader	General Partnership	Limited Company	Limited Liability Partnership (LLP)
Legal Personality and Structure	No legal personality	No legal personality	Body corporate	Body corporate
Ownership	Individual	Partners	Shareholders	Members
Management	Individuals	Partners	Directors	Members
Governing documents	None	Partnership Deed	Articles and Shareholders	Members Agreement
Limited Liability	✗	✗	✓	✓
Disclosure	Minimal	Minimal	Extensive	Moderate
Financial entitlements	Profits earned directly	Profit share (with drawings on account)	Dividends and salary	Profit share (drawings on account)
“Investibility”	✗	✗	✓✓✓	✓
Tax treatment	Sole trader taxed directly	Tax transparent (Partners taxed directly)	Corporation tax on profits	Tax transparent (Members taxed directly)
International recognition	✓✓✓	✓✓	✓✓✓	✓✓
Governing legislation	General contract law	Partnership Act 1890	Companies Act 2006	Limited Liability Partnerships Act 2001

9. Conclusions

This note is intended to provide a snapshot of the main business entities available to UK businesses. The key considerations are summarised in the table above. Business owners should carefully consider which vehicle is most suited to their own needs, operational requirements and long-term objectives and take both legal and accounting advice from the outset.

Farrer & Co's Corporate team acts regularly for founders, start-ups and new businesses and offers bespoke advice to businesses at all stages of their lifecycle.

10. Key contacts



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Excellent market knowledge, very commercial, pragmatic and practical advice.

- Corporate M&A, Legal 500 2020

11. Glossary

Term used	Definition
Articles of Association	the main constitutional document of a company which governs its operation and management
Body corporate	an entity with its own legal personality, distinct to that of its members
Companies House	the public registry whose head is known as the "Registrar of Companies". Companies and LLPs must incorporate with Companies House and it is Companies House who record and retain the requisite information (such as Confirmation Statements and accounts) which these entities must disclose. Companies House must also be notified for certain changes to take effect, such as changes of name
Confirmation Statement	the statement which companies and LLPs must file with Companies House at least once a year confirming that the information held by the company/LLP is up to date
Disclosure	the requirement for a business to offer up certain information to regulatory and registry bodies (such as Companies House), as well as the general public
Incorporation	the founding of a company or LLP
Joint and several liability	when two or more people assume joint responsibility for something (e.g. payment of a single sum under a contract) and can fulfil the obligation separately. Either party can fulfil the obligation, either party can be held responsible for failure to fulfil the obligation, and the party who has been enforced against can then pursue the other party for a financial contribution
Members Agreement/LLP Agreement	the constitutional document of a limited liability partnership
Memorandum of Association	a legal document which is signed by the founding members of a company. Since the Companies Act 2006, this is a relatively uncomplicated document that simply records the members' wish to form a company
Partnership Deed	the constitutional document of a general partnership
Shareholders Agreement	a private contractual governance document which shareholders of a company may enter into
Tax Transparency	for partnerships and LLPs, this term means that they are not taxed as separate legal entities. The partners/members are instead taxed directly
Winding up	the process of dissolving a business

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