Department for Business Innovation & Skills

A GUIDE TO LEGAL FORMS FOR BUSINESS

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Guide to Legal Forms

Unincorporated legal forms:

The distinguishing feature of unincorporated forms is that they have no separate legal personality. There are three main forms:

Sole Trader

This is the simplest way to set up and run a business: ownership and control of the business rests with a single individual. Being a Sole Trader is inherently risky because the individual is not separate from the business and has sole unlimited personal liability for the business, its debts and contractual obligations, and any claims against it. They own all the assets of the business and can dispose of them as they wish, and may employ staff and trade under a business name. However it is unlikely that sole trader status will be suitable for businesses which need more than a small level of external investment – being unincorporated limits borrowing and prevents the business raising equity finance by issuing shares.

Regulation for the Sole Trader is minimal: there is no requirement for a formal constitution for the business, and no need to register or file accounts and returns with Companies House. Sole Traders are treated as self-employed by HMRC and must register and make an annual self assessment tax return – profits from the business are treated as personal income subject to income tax and national insurance contributions.

Unincorporated Association

Unincorporated Associations are groups that agree, or ‘contract’, to come together for specific purpose. They normally have a constitution setting out the purpose for which the association has been set up, and the rules for the association and its members. They are typically governed by a management committee. All members of the management committee will again have unlimited personal liability, unless they are specifically indemnified in the constitution. As for a Sole Trader, there is a limitation on raising finance, minimal regulation, and self-employed tax status for management committee members.

Partnership

A Partnership is a relatively simple way for two or more legal persons to set up and run a business together with a view to profit. A partnership can arise, without any formal agreement, when people carry on a business in common, but typically there is agreement to trade as a partnership. Partners will usually draw up a legally binding partnership agreement, setting out such matters as the amount of capital contributed by each partner and the way in which they will share the profits (and losses) of the business.

Again the Partnership has no separate legal personality. Partners share the risks, costs and responsibilities of being in business. Because partners generally bear the consequences of each other’s decisions, partners usually manage the business themselves, though they can hire employees. Partners usually raise money for the business out of their own assets, and / or with loans, although again being unincorporated limits borrowing in practice, and not being a company with a share capital prevents the business itself from raising equity finance by issuing shares.

Each partner is self-employed and pays tax on this basis on their share of the profits: The partnership itself and each individual partner must make annual self-assessment returns to HMRC, and the Partnership must keep records showing business income and expenses.

Legal persons other than individuals – such as Limited Companies or Limited Liability Partnerships – can also be partners in a partnership. They are treated like any other partner except that they have additional tax and reporting obligations – for example companies must pay corporation tax rather than income tax on their profits from the partnership.

Limited Partnership

Not to be confused with a Limited Liability Partnership (see below) – a Limited Partnership has two sorts of partner: general partners and limited partners. The form is similar to a Partnership, with the main differences being that the limited partners may not be involved in the management of the business and their liability is limited to the amount that they have invested in the partnership. Note that limited partners are different from ‘sleeping’ partners in a Partnership or Limited Partnership, who do not take part in running the business but remain fully liable for its debts. Limited partnerships must register at Companies House, and do not come into existence until they are registered. Changes to the partnership must also be registered.

Trust

Trusts are unincorporated and have no legal identity of their own. They are essentially legal devices for holding assets so as to separate legal ownership from economic interest. A trust holds assets on behalf of an individual or another organisation and governs how they are to be used. A trust is run by a small group of people called trustees who are legally responsible for the administration of the trust and personally liable for any debts or claims against it that cannot be met out of the trust’s own resources. Trusts make their own set of rules – enshrined in a trust deed – which sets the trust’s objectives and may be used to ensure that assets and profits are used for a particular purpose. Trusts do not typically raise finance – they simply manage assets and do not distribute profits. Trusts are often used in conjunction with unincorporated associations, which cannot themselves own property.

Incorporated legal forms

Limited Company

The Limited Company is the most common legal form in use for running a business. Companies are ‘incorporated’ to form an entity with a separate legal personality. This means that the organisation can do business and enter into contracts in its own name.

On incorporation under the Companies Act 2006, a company is required to have two constitutional documents:

- a Memorandum, which records the fact that the initial members (the subscribers) wish to form a company and agree to become its members. The Memorandum cannot be amended; and

- Articles of Association – often just referred to as the Articles – which are essentially a contract between the company and its members, setting the legally binding rules for the company, including the framework for decisions, ownership and control. The Companies Act 2006 provides significant flexibility to draw up articles to suit the specific needs of the company, provided it acts within the law.

A Limited Company is owned by its members – those who have invested in the business – and as the name suggests they enjoy limited liability – i.e. the company’s finances are separate from the personal finances of their owners and as a general rule creditors of the business may only pursue the company’s assets to settle a debt. The personal assets of the owners are not at risk. There are two mechanisms for company membership:

Company Limited by Shares Most companies fall into category. Members each own one or more shares in the company and are therefore known as shareholders. Shareholders’ limited liability means that they only stand to lose what they have already invested or committed to invest (amounts unpaid on shares).

Company Limited by Guarantee Members of the company give a guarantee to pay a set sum if the company should go into liquidation.

A company must have at least one member. In a Company Limited by Shares, each share usually has a voting right attached to it so the members are able to vote on important decisions affecting the company. The arrangement is normally one share one vote, although many companies will create different classes of share with different voting rights attached. In a Company Limited by Guarantee the arrangement is usually one member one vote (OMOV).

Day to day management of a company is nominally separate from its ownership and undertaken by a director or board of directors, with the core principle that they act in the interest of the company and its members. However, directors may also be members, thus the simplest form of Limited Company is a single member who owns the whole company and is also its sole director. A company must have at least one director (public companies described below must have two) and at least one director must be a real person.

In a Company Limited by Guarantee, finance comes from the members, from loans or from profits retained in the business as working capital. A Company Limited by Shares can also raise capital from shareholders in return for a stake in the business – any profits from the business are usually distributed to shareholders in the form of dividends, apart from profits retained in the business as working capital. Limited Companies have a greater capacity to finance themselves with loans than unincorporated businesses, as they can use their assets as security for loans, creating a ‘charge’ over the company’s assets. These charges are registered at Companies House, providing transparency about the extent of a company’s secured credit. Lenders, including banks and building societies will therefore typically make incorporation a condition of providing a business loan.

The Limited Company form is subject to stricter regulatory requirements than unincorporated forms: greater accountability and transparency is the price to pay for the benefit of limited liability. Accountability is both to the company’s shareholders and also to the public who may wish to deal with the business. Companies are registered at Companies House, and it is the directors’ responsibility to maintain the company’s public records – including annual accounts and an annual return about the company – and to file them at Companies House. They must notify Companies House of changes in the structure and management of the business.

If a company has any taxable income or profits, it must tell HMRC that it exists and is liable to corporation tax. Companies liable to corporation tax must make annual returns to HMRC.

A Company Limited by Shares is either a Private Limited Company (Ltd) or a Public Limited Company (Plc). The key difference is that the Public Limited Company is permitted to offer shares for sale to the public. The Private Limited Company is the most common legal form used by the vast majority of businesses – ranging from a business with a single shareholder director to large companies which have attracted large investments of private equity capital. Public Limited Companies usually begin life as Private Limited Companies but later go public for the advantage that this provides in raising finance. A Public Limited Company must have at least two directors and a qualified company secretary. It must have issued shares to the public to a value of at least £50,000. Public companies attract stricter regulation than private companies to ensure transparency and protection for the public investor, who is often more separated from the management of the company than in a private company.

A Public Limited Company may also become a Listed Company by floating its shares on a recognised stock exchange, creating a wider market for its shares. Listed companies are subject to even greater regulatory requirements in the form of listing rules and information disclosure requirements put in place to ensure the market works and maintains its integrity.

Limited Liability Partnership (LLP)

A Limited Liability Partnership is a body corporate with a separate legal personality similar to a company. Unlike in a normal partnership, the members of an LLP enjoy limited liability as the name suggests – 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. Each member takes an equal share of the profits, unless the members’ agreement specifies otherwise.

Much like a Partnership, each non-corporate member of an LLP needs to register as self-employed with HMRC, and both the LLP itself and each individual member must make annual self-assessment returns HMRC. Non-corporate members of an LLP pay income tax and national insurance contributions on their share of the profits. Additionally, LLPs must register and file accounts and annual returns at Companies House. At least two members must be “designated members” who hold additional responsibilities – it is they who appoint auditors and sign off and file the accounts at Companies House.

Limited Liability Partnerships have much more freedom than companies over arranging their internal affairs, for example in the way in which decisions are made, and the way in which profits are distributed to members.

Community Interest Company (CIC)

A Community Interest Company (CIC) is a form of company (limited either by shares or by guarantee) created for so called ‘social enterprises’ that want to use their profits and assets for community benefit. CICs are easy to set up and have all the flexibility and certainty of the company form, but with several special features which ensure they serve a community interest:

- First, all companies applying to be registered as CICs must submit a community interest statement to provide the CIC Regulator with evidence that they will satisfy a community interest test defined in law. The company must continue to satisfy the test for as long as it remains a CIC, and must report annually to the Regulator.

- Second, a CIC must have an “asset lock” which restricts the transfer of the company’s assets (including any profits generated by its activities) to ensure that they are used for the benefit of the community.

- Third, CICs are subject to caps on dividends and interest payable – to strike a balance between encouraging people to invest in CICs and the principle that the assets and profits of a CIC should be devoted to the benefit of the community.

Charitable Incorporated Organisation (CIO)

The Charitable Incorporated Organisation (CIO) is a new legal form which will be available to charities in England and Wales from 2012. Currently charities wanting to incorporate normally do so as a Company Limited by Guarantee – which means dual registration with Companies House and the Charity Commission and dual regulation under company law and charity law. CIO status will offer the benefits of incorporation, but the organisation will only be registered with the Charity Commission and regulated under charity law. The new form is expected to be used primarily by small and medium charities. Like any charity the organisation’s profits and assets will be locked in for charitable purposes. Note that charity law and regulation are devolved: similar legislation has been passed in Scotland, but not yet in Northern Ireland.

Industrial and Provident Society

An Industrial and Provident Society (sometimes referred to as an I&P, or IPS) may take one of two forms:

Co-operative Society (Co-op)

A Co-operative Society is a membership organisation run for the mutual benefit of its members – serving their interests primarily by trading with them or otherwise providing them with goods, services and facilities – with any surplus usually being ploughed back into the organisation, although profits can be distributed to members. A Co-operative Society may or may not be a social enterprise, depending on its activities and how it distributes its profits.

A Co-operative Society is governed by rules, which must reflect the co-operative values and principles set out by the International Co-operative Alliance. The Alliance defines a co-operative as an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through jointly owned and democratically controlled enterprise.

A Co-operative Society is incorporated – and so has a separate legal personality – and must register and submit annual accounts to the Financial Services Authority (FSA) rather than Companies House. As with a company, the members' liability is limited to the amount unpaid on shares. They have a principle of open membership and can therefore raise funds by issuing shares to the public.

They are run and managed by their members, usually through a committee of officers, similar to a company's board, that manages on members' behalf. However, members always have democratic control on a "one member one vote" (OMOV) basis, regardless of size of respective shareholdings, under the co-operative values and principles.

Community Benefit Society (BenCom)

A Community Benefit Society (BenCom) is similar to a Co-operative Society except that it conducts business for the benefit of the community, rather than the members of the society. Indeed a BenCom must be run primarily for the benefit of people who are not members of the society and must also be in the interests of the community at large. Profits are not distributed among members, or external shareholders, but returned to the community. BenComs also often apply an asset lock, which protects their assets for the future benefit of the community. It is unusual for the BenCom to issue more than nominal share capital (eg one share valued at £1 per member. If more than nominal share capital is issued or if members make loans to the BenCom, dividends and interest paid are capped at a reasonable rate needed for the business to retain the capital it needs.

A BenCom can be established as a charity, providing it has exclusively charitable objects that are for the public benefit, allowing them to raise capital through public grants and charitable trusts. If approved, they're known as exempt charities – reporting only to the Financial Services Authority (FSA), not the Charity Commission. Charitable BenComs must have an asset lock.

Financial Mutuals

There are three other types of mutual form, not covered in detail here, that specifically exist to provide financial services. These are also registered with the FSA.

- ***Building Society Building*** Societies are mutual financial services institutions, primarily providing residential mortgage lending, but also other financial services such as other forms of lending and investment, money transmission services, banking and insurance services. They are funded substantially by their members.

- ***Credit Union*** A credit union is a cooperative financial institution that is owned and controlled by its members and operated for the purpose of providing credit at reasonable rates, and providing other financial services to its members.

- ***Friendly Society*** A friendly society is a voluntary mutual organisation whose main purpose is to assist members financially during sickness, unemployment or retirement, and to provide life assurance.

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Any enquiries regarding this publication should be sent to:

Department for Business, Innovation and Skills
1 Victoria Street
London SW1H 0ET
Tel: 020 7215 5000

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