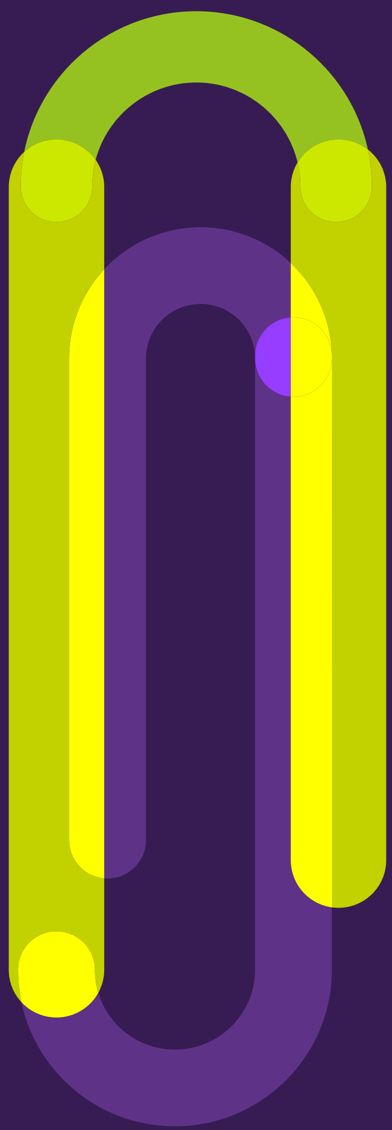
A Beginner's Guide to Trading Status

jelfsmallbusiness.co.uk
01905 888397

If you're thinking of starting your own business, then you may have come across the term 'trading status'. But what is it, and how does it affect your business?

In this simple beginner's guide, we'll go through why trading status is important and what options you have as a business owner.



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What is a trading status?

A trading status is the legal structure of your business, and therefore represents the way your company is seen by **HM Revenue & Customs** (HMRC) and the wider law. The type of trading status that your venture holds affects many different aspects of running a company.

Special statuses apply to organisations which don't make a profit or do so solely to serve a social function. However, for small business owners setting up companies for the purpose of making an income for themselves or other private individuals, most businesses in the UK will fit into one of three trading status categories:

- **Sole trader**
- **Limited company**
- **Business partnership**

Shortly we'll go through the specific differences between these trading statuses and what the pros and cons of each are, but first we'll discuss why exactly they're so important.

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Why do you need to choose a trading status?

The type of paperwork you have to fill in to keep accurate company records, the taxes you will have to pay on your income, how you can take profit from the company and what your legal liabilities are for any losses it makes are all dictated by the trading status your company has.

While there are many things to think about when starting a new business, **getting your trading status in order should be your top priority** - you simply won't be able to plan effectively without knowing how you need to organise your tax affairs and paperwork. Bad planning at the early stages of a new business can cause huge problems later on, and is a common cause of small businesses failing in their early years.

Because businesses grow and evolve over time, you have the option of changing your trading status at any point. So if you want to take your business in a different direction to take advantage of say, new investment from a third party or a change in the market conditions, you have the option to switch. However, changing a trading status can involve a lot of time spent filling out paperwork, and may in some cases involve a financial cost; **time and money** are often things that small businesses can ill-afford to waste, so while you can't predict the future, it's worth being as sure as you can be about your chosen trading status from the outset.

Sources: BBC.co.uk, GOV.uk, HMRC

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What are your options?

Let's look in more detail at the three main types of trading status used by UK businesses:

Sole Trader

Some people assume that 'sole trader' means one person working on their own, but this isn't necessarily true. Being a sole trader actually means you take **full personal responsibility** for the running of the business - you can still hire staff if you wish to.

Being personally responsible for the business as an individual means you get to keep all your business's profits after you've paid tax on them. However, because the law sees you and your company as the same thing, you are personally responsible for any losses your business makes. This may mean that you may eventually have to pay off debts accrued by your business out of your own pocket, potentially putting personal assets such as a home or a car at risk.

Sole traders must pay Income Tax on their profits, make National Insurance contributions and complete a Self Assessment tax return every year.

Limited Company

When you set up a limited company, you're creating an organisation specifically to run your business. This separates your **business dealings** from your **personal finances**, and any profits made belong to the company. These profits will be liable for Corporation Tax, but once this is paid the profits can be shared out among the company shareholders. If you are the only shareholder, then you receive all the profits.

If you're a shareholder, you don't necessarily have to be involved in the running of the business. This is done by the board of directors, who have no liability for the losses the company makes if they're not shareholders.

Public limited companies, or plcs, are limited companies where a proportion of the shares are made available for the public to buy on the stock exchange. However, these are usually much larger businesses, and this is not an approach typically taken with a small business startup.

A limited company pays shareholders though its profits, usually in one of two ways: salary or dividends. A dividend is a payment made to shareholders in the company, and is paid once profits have been declared and tax paid on them, giving each shareholder a fixed amount according to the size of their shareholding. If you want a regular salary from your limited company, then you will have to ensure that it is registered as an employer with HMRC. This means that after having paid Corporation Tax on its profits, the company will then have to take **Income Tax** and **National Insurance** contributions from your salary, as well as paying employers' National Insurance contributions.

Legal liability for what happens when a limited company goes bust can be quite complicated, but essentially, how much money you have to put into the business if it goes bust with debts owing depends on how much money you have already put in for ownership of the company's shares. To make it a little clearer, HMRC gives this example:

A company limited by shares issues 100 shares valued at £1 each when it's set up. Its two shareholders own 50 shares each and have both paid in full for 25 of these.

If the company goes bust, the maximum the shareholders have to pay towards its outstanding bills is £50 - the value of the remaining 25 shares that they've each not paid for.

If you're starting a limited company, then you must register the firm with **Companies House** and let HMRC know when business activities have begun. Each year, you're then required to put together statutory accounts, send an annual return to Companies House and submit a Company Tax Return.

Sources: BBC.co.uk, GOV.uk, HMRC

Business Partnership

Setting up your company with a business partner means its legal liabilities are similar to those for a sole trader, except those liabilities are **shared equally between the partners**. Any profits made by the company are owned by the partners, and these are divided up equally before each partner pays Income Tax and National Insurance Contributions on their own share.

To set up a business partnership, there must be one 'nominated partner'. This is the person who is responsible for keeping business records and registering the partnership with HMRC. All partners will have to register for **Self Assessment** and complete a tax return every year, while the nominated partner will also have to complete a partnership tax return.

Not all business partnerships have to work in the same way, however, and there are different approaches that you can take. You can register your partnership as a limited partnership, meaning it works in a similar way to a limited company. Also, there's no requirement for your business partner to be a person - you could go into partnership with a separate limited company.

Sources: BBC.co.uk, GOV.uk, HMRC

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What do you need to consider?

Each trading status has its advantages and disadvantages, so which one is right for you depends on your own situation. Ideally you're looking for a trading status where the advantages will be hugely beneficial and some of the disadvantages are not that much of an issue for you.

Consider carefully the following pros and cons:

	Advantages	Disadvantages
Soul Trader:	• **Easier** to set up than a limited company, with less paperwork • **Freedom** to make your own decisions about the business • Business **profits belong to you** and no Corporation Tax is paid	• You are **personally liable** for any losses you make, which could put personal assets at risk • Sole traders have **no one to help** with the running of their business, so need some ability with accounting or the money to pay an accountant
Partnership:	• Choosing the right partner could result in **shared expertise** which will help you run the business • **Time and responsibility** for managing the business is **shared** • **Liability** for business losses is **shared** • **Profits** belong to the partners	• Partners are **personally liable** for any losses the business makes • **Disputes** can arise between partners when one feels another is not taking a fair share of responsibility for running the business
Limited Company:	• Limited companies have their **own identity**, so shareholders only have limited liability for losses the company makes • Electing third parties to the board of directors means you can take a **back seat** to the running of the business • **Choice** of how company profits are paid to shareholders: salary or dividend	• There is **more paperwork** required for setting up and running a limited company • Limited companies are **liable for Corporation Tax**

Another point to consider is that whatever status you choose, you must register your company for VAT if you anticipate that its takings will be more than £81,000 per year.

Sources: BBC.co.uk, GOV.uk, HMRC

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Why is it important you choose the right one?

Looking at the pros and cons of the different trading statuses, you can see how choosing an unsuitable one may cause problems. For example, if you're operating in a high-risk market, being a **sole trader** means your home or personal savings may be in danger should the business fail. In circumstances such as this, starting a **limited company** would be a more sensible approach.

Alternatively, if you're a tradesperson such as a plumber or electrician, being a limited company will not only mean that paperwork will cut into your available working hours, you'll also find that **Corporation Tax** is taking a chunk out of your profits. Since a tradesperson typically does not take on large debts in setup costs, in this case being a sole trader would be more appropriate.

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Conclusion

Getting your trading status right is the first step towards launching your business, so you need to consider all the possibilities before you make a decision. In this guide we've outlined the basics to get you thinking in the right way about how your trading status will affect the way your business works, and therefore the way you work.

If you need any more information on how trading statuses work or what your specific tax liabilities will be with each kind of status, it's recommended that you speak to an independent financial advisor. You should also seek specific legal advice on contracts if you're entering into a partnership with any other individual(s) or company.

Sources:

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