

CHOICE OF BUSINESS MEDIUM

This essay shall consider the range of factors that will influence the choice of medium for a newly established business.

Various factors need to be considered when deciding whether to set up as a sole trader, a partnership or company. You will make the choice when a new business is set up, but should keep the type of medium under review as the circs (and the law) change. Generally, each medium has some advantages and some disadvantages, so sometimes it can be a hard decision. We will consider:

- risk of capital
- expense
- management
- publicity
- taxation – trading profits
- interest relief
- capital gains
- inheritance tax
- pensions and social security, and
- raising finance

1) Risk of capital – all businesses involve a risk of capital, yet the degree of risk depends on:

- the nature of the business,
- the economic climate, and
- the skill of those running the business.

The amount of capital which is at risk will also vary since some types of business require a great deal of capital, yet others very little.

Disadvantage of a partnership –

a) No limited liability – if a partnership becomes insolvent, each partner is joint and severally liable for all the debts of the partnership and that liability is unlimited. So a partner stands to lose what they have invested and also their personal assets / property. The partnership agreement may provide for how losses are to be shared, but creditors will still be able to claim in full from a rich partner if the poor partner(s) can't pay.

2) Expense

Advantage of a partnership

a) Lower start up costs – there are no registration requirements and so the company start up costs are not incurred. However, in most cases a partnership agreement will be wanted and so there will be fees in instructing the solicitor to draft it. (The fees for drafting the documents (whether the mem + articles or the agreement) may be similar though).

b) Lower running costs

In addition to legal advice, owners of a new business will often want to seek advice from accountants, and the amount this costs will depend more on the complexity of the advice rather than the medium used.

Additional costs for both will be printing costs (of business letter paper) – these expenses are only *necessary* in the case of a company (which must comply with the CA 1985 relating to the name, number and address of the company) but will often be done by a partnership too.

Formation costs and running costs will depend largely on the size of the business, whether a company or a partnership.

3) Management - a partnership may provide its own rules for management of the business. The PA 1890 lays down certain presumptions (eg, that in the absence of a contrary agreement, certain decisions are taken by a majority vote and certain decisions require unanimity). Partners can vary these rules by agreement or a course of dealings.

a) Internal flexibility - changes to the partnership agreement normally requires unanimity of all the partners, so the partnership constitution may be more rigid than that of a company. Yet when the agreement is drawn up, the partners may decide to allow for greater flexibility and provide for alteration by a majority, either in general or particular cases.

b) Security of position - if the partnership agreement doesn't provide to the contrary, the removal of a partner will involve dissolution of the partnership. Yet in practice, it will sometimes be possible for some of the partners to get rid of one other partner and then set up a 'new' business (which will be like continuing the old one) – especially if they own the previous premises.

c) Succession to the business - the partnership agreement may provide for bringing in new partners and paying the existing partners on leaving. If the partnership agreement is silent, unanimity is required for the admission of a new partner.

d) Legal status:

- a partnership is not a separate legal person
- partnerships cannot create floating charges
- a partnership is not bound by the ultra vires doctrine so is free to change the nature of its business unanimous agreement is needed, although outsiders won't be affected even if there is no unanimity)
- partnerships (other than in certain professions) are limited to 20 members

4) Publicity - partnerships are not required to make such info available (although in practice, the partners will be required to show their accounts to any prospective lender).

5) Taxation – trading profits

All the income profits of a partnership are taxed as income of the partners whether they are actually paid to them or retained in the business (unless a capital allowance is available).

A pship offers less scope for tax planning in relation to income profits than a company. All the income profits are taxed as income of the partners whether they are actually paid to them or retained in the business (unless a capital allowance is available).

When profits are withdrawn from the business, a partner is in the same position as a director receiving directors' fees – both pay income tax on the sums that are received.

The preceding year basis for pships used to be an incentive against forming a company when a new business was set up. Yet because of the change to the system, any new business will now be immediately taxed on a current year basis. Yet still bear in mind that a payment of a salary to a director will suffer an immediate deduction for tax under the PAYE system, whereas drawings by a partner will not.

When profits are retained in the business, partners still pay the same tax as if the profits had been withdrawn. This will be an advantage when compared with a company where the partner's rate of tax is less than the rate of corporation tax, and a disadvantage when it is more.

6) Interest relief – interest must usually be paid out of income after it has been taxed, yet sometimes it can be paid before tax (as a 'charge on income'), so that tax relief is available on the interest payment. As regards pships, this relief is available where money is borrowed to buy an interest in a partnership.

7) Capital gains - the disposal of assets by a pship gives rise to tax at the appropriate rate or rates of the partners (which is likely to be 20% or 40%).

In the case of a pship, each partner is entitled to an annual exemption for the first £8,500 of gains during each tax year.

Taper relief – taper relief is available to individuals. One downside of taper relief is that it is calculated in respect of complete years of ownership, whereas indexation effectively takes into account monthly period of ownership.

8) Inheritance tax - gifts of pship assets will be liable to tax as gifts of the individual partners.

Business property relief – any pship share attracts 100% business property relief on its subsequent transfer (check).

A partner whose private property is used by his pship is entitled to relief of 50% when he gives the property away.

9) Pensions and social security - partners can get the relief by means of a personal pension. Contributions are deductible from taxable income up to a certain percentage of relevant earnings depending on the age of the contributor. However, the relief is limited to the appropriate percentage of £102,000 in the case of partners whose income exceeds this figure.

Social security operates differently in respect of empees and the self employed. Contributions must be made by both empr and empee in respect of an employed person; a self-employed person must contribute at a higher rate than the empee's contribution but lower than the empr's and empee's contributions combined.

The benefits to which an empee is entitled to are higher overall than those to which a self-employed person is entitled.

10) Raising finance - it is not as easy to invest capital in a partnership: an investor in a partnership will ideally have to be made a partner if they are to have a stake in the business (which can disrupt the management structure and will also be unappealing for the investor who will then have unlimited liability for debts). A partner who wants to exit his investment will have to sell it in its entirety to the existing partners. Alternatively, an investor could simply lend money to the partnership, yet there will be no capital growth like there would be if he became a partner and took a partnership share.

By way of conclusion, the choice of business medium is a decision for each individual based upon his or her business needs. Whilst weight should be given to the above factors in no particular order of priority, they must all be considered in turn and a wise entrepreneur would be well advised to give serious consideration to the above before deciding upon the choice of business medium that best suits his or her particular needs.

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