Sole traders and SMEs: better business structures

OMB | Personal tax



20 March 2024

We consider the pros and cons of small business models and ask whether more sole trader businesses should focus on becoming partnerships or limited liability partnerships.

Key Points

What is the issue?

In terms of actual businesses operating in the UK, there are many more sole traders than companies. We have 3.1 million sole traders, representing 56% of all businesses. Just 7% of businesses, so around 365,000, are run as partnerships.

What does it mean for me?

The Enterprise Management Incentive scheme is highly attractive to smaller companies because the criteria for the issuing company is that it has gross assets of less than £30 million and fewer than 250 full-time equivalent employees.

What can I take away?

The recent reduction in the rate of NICs, coupled with an unfavourable main rate of corporation tax, now surely mean that a partnership or the limited liability partnership will become the business model of choice for ambitious small businesses.

According to government statistics, there are 4.8 million companies on the Companies House register that have a shareholder who has an interest of 2.5% or more in the company. Of these companies, 2.1 million are actively trading. The government estimates that there are between 6.4 million and 10.9 million non-corporate shareholders.

In terms of actual businesses operating in the UK, there are many more sole traders than companies. We have 3.1 million sole traders, representing 56% of all businesses. Just 7% of businesses, so around 365,000, are run as partnerships.

We really are a nation of small businesses but the fate of the small business barely features in the news. Judging by the recent Spring Budget, it is far from the chancellor’s mind.

Small business models

In this article, I am weighing up the pros and cons of small business models and wondering whether more sole trader business should focus on becoming partnerships or limited liability partnerships rather than companies, if they have growth in mind.

Making Tax Digital (MTD) for Income Tax is now just two years away. It commences on 5 April 2026 for self-employed businesses and landlords with business turnover above £50,000 and on 5 April 2027 it will be extended to self-employed businesses and landlords with business turnover above £30,000.

MTD for Income Tax comes at a financial cost: will this lead to a surge in cost-motivated incorporations? It is easy to forget that for the smallest business, an extra ‘couple of hundred quid’ is a material sum.

What business structure might be preferable for those who are determined to maximise their cash savings and avoid quarterly reporting? One suggestion, if the business owner has an ‘available’ spouse or partner, is to transform the business into a partnership or limited liability partnership, instead of following the more typical company incorporation route.

But first, a question then arises as to what to do about VAT.

Value added tax

The chancellor’s decision to increase the VAT threshold, after it was frozen for six years, was well overdue. It is disappointing, however, in terms of the economy at least, that it only increased by £5,000 as it holds businesses back.

Often small business owners are locked in the ‘small business mentality’ whereby they take extreme actions to avoid costs and bureaucracy. This means (and this is a real example) that a sole trader might elect to only open a café at lunch times, three times a week to remain under the VAT threshold. This all comes at the cost of leaving a perfectly good business premises vacant for the other four days and a gradual running down of the customer base. There are other good reasons for not opening all week, such as excessive energy costs.

As small business rates relief presently applies, there are no rates demands and thus no incentive to work to pay that overhead. There is such a huge step up required in terms of the business owner’s effort that if he or she opens for an extra day per week, they run the risk of exceeding the VAT turnover threshold, potentially resulting in a 20% hike in prices, depending on the extent to which input VAT is recovered. A price increase may well affect competitiveness, besides which additional staff may be needed!

Rewarding employees

Despite the negative effects of a decade of ‘fossilised’ tax allowances, it is a fact of life that some small businesses never want to grow, while others dream of bigger things. To grow you need to employ staff, or else you must outsource. In terms of employees, government statistics show us that large companies, which account for less than 1% of total businesses, employ 40% of workers. SMEs account for 99.2% of business by number (although not turnover or profits) and they employ around 60% of staff.

When it comes to rewarding and incentivising staff, an effective way to retain staff is through an employee share scheme. The statistics reveal that only a very few employers offer share schemes; in fact, just 16,330 by the end of 2021. Use of these schemes has grown by 6% in the tax year ending 2020, and has grown by a total increase of 88% since the tax year ending 2010.

Larger companies tend to offer more complex share schemes such as Save As You Earn schemes and Share Incentive Plan schemes. Unlike the Enterprise Management Incentive, these schemes must be offered to all employees.

The Enterprise Management Incentive scheme

The Enterprise Management Incentive scheme is highly attractive to smaller companies and of little use to large corporations because the criteria for the issuing company is that it has gross assets of less than £30 million and fewer than 250 full-time equivalent employees.

One of the main drawbacks to an Enterprise Management Incentive scheme is that the company must satisfy the ‘qualifying trade’ test. A trade will not qualify if one or more excluded activities together amount to a substantial part of it. Excluded trading activities include:

- dealing in land, commodities or futures, or shares, securities or other financial instruments;
- dealing in goods, other than in the course of an ordinary trade of wholesale or retail distribution;
- banking, insurance, moneylending or other financial activities;
- leasing;
- providing legal or accountancy services; and

- property development, farming or market gardening.

This means that a vast number of smaller businesses cannot use a scheme designed for smaller businesses. I do not know the legislative background as to why there are quite so many excluded activities when it comes to the qualifying activities criteria for Enterprise Management Incentive schemes. It does seem that government could review the rules with a view to changing them for a modern financial and serviced-based economy.

Exercising Enterprise Management Incentive scheme options

Statistically, companies are most likely to grant options under the Enterprise Management Incentive scheme. However, although a lot of options are being granted, not that many are ever exercised and result in employee share ownerships. It is worth asking why that is.

Enterprise Management Incentive scheme options vest – in other words, they become exercisable – when certain conditions as laid down in the scheme are met. Typically, there might be performance targets; for example, if you remain in the employment for a specified number of years or if you achieve another key performance indicator.

Many Enterprise Management Incentive schemes are drafted as ‘exit based’. This means that the employee is only able to exercise their options (to buy shares) when there is a sale of the company’s shares. The advantage for the issuing company is that it does not need to rewrite its articles to add leaver clauses for employee shareholders. More is the pity; it is surprising how many companies formed with model articles never actually read those articles and reflect on their meaning.

The disadvantage for the employees of a scheme which only permits exit-based vesting is that they may have an exceptionally long wait for any exit event. That event may never happen or, worse still, the employer may go out of business.

It is obvious that many employees in Enterprise Managing Incentive schemes are getting a bad deal: if you are granted Enterprise Management Incentive scheme options, it is most likely that you are never going to be able to exercise them. Perhaps one answer is that company owners could be more inventive when it comes to creating such schemes, such as creating schemes that tie into key performance

indicators.

Share scheme options

The UK government offers four share schemes that have tax-advantages to both employers and their employees. Save As You Earn and Share Incentive Plans are for all employees. Company Share Options Plans and Enterprise Management Incentives are for certain employees at the discretion of the employer.

- **Enterprise Management Incentive scheme:** This scheme is the largest contributor to tax relief, and the average value of Enterprise Management Incentive scheme options in the 2020-21 tax year was £11,650, reflecting the significantly higher limits on the maximum value of options that can be granted under the scheme. Also, Enterprise Management Incentive scheme options may be offered to select employees (rather than all employees).
- **Company Share Option Plan:** Larger companies may favour the Company Share Option Plan to incentivise key staff. This is limited to £30,000 per employee. The average value of scheme options in 2020-21 was £5,290.
- **Save as You Earn:** £2.59 billion in Save as You Earn (SAYE) options were granted for the tax year 2020-21, which is the largest aggregate value of tax-advantaged employee share schemes. However, the average value per employee for SAYE was £6,720 (due to SAYE having a large number of participants as the scheme is available to all employees).
- **Share Incentive Plans:** The average value of a Share Incentive Plan in 2020-21 was just £210 per person.

The power of partnerships

All companies considering share-based rewards must consider the Employment Related Securities anti-avoidance rules in Part 7 the Income Tax (Earnings and Pensions) Act 2003.

Small companies often do not intentionally set up a share scheme for reward but rather out of necessity when the owner is considering succession planning. Herein lies the rub: is it not better in terms of succession to have been trading all that time as a partnership or limited liability partnership and thus avoid the Employment

Related Securities anti-avoidance rules?

This is where partnerships become more attractive. Succession planning and promotion is far more flexible with a partnership (or limited liability partnership) because there is no share capital, so partners do not have to worry about Employment Related Securities. There is no need for an Enterprise Management Incentive scheme, and no prohibition in your types of trading activity will defeat your staff incentive planning. There are no close company distribution rules either.

It’s not all win-win. Partnerships and limited liability partnerships must consider the anti-avoidance rules that potentially apply to them. These are the salaried members rules and the mixed members rules in the Income Tax (Earnings and Pensions) Act 2005 Part 9.

The salaried members rules are the partnership equivalent of ‘IR35’ by trying to tax ‘disguised remuneration’. They work as follows: if a limited liability partnership has a member who is in reality only an employee, because they are paid a fixed salary, they have no significant influence over the affairs of the partnership; nor have they made any financial contribution to the business. That employee’s ‘share’ partnership income will be taxable under PAYE.

If a partnership or limited liability partnership has ‘mixed members’, further anti-avoidance rules cut in when: there is a combination of individual and non-individual members (i.e. corporate members or trustee members); and profit allocation is such that a non-individual member receives a greater share of the profits than is reasonable given their input into the business. The arrangement must be such that an individual member is able to enjoy those profits in some way. If so, the mixed membership rules apply to redirect the taxable profits allocated to the non-individual to the individual instead.

A disadvantage of trading as a partnership maybe that sizeable chunks of tax reliefs only apply to companies. You can solve that to an extent by including a corporate partner, which may benefit from reliefs such as full expensing for capital allowances and even research and development relief.

Looking at a ‘tax-motivated’ choice of business vehicle, the recent reduction in the rate of National Insurance contributions, coupled with an unfavourable main rate of corporation tax, now surely mean that a partnership or a limited liability partnership

will become the business model of choice for ambitious small businesses.

© Getty images/iStockphoto