

# Importance of Limited Liability

## Sole traders

Most businesses in the UK are small businesses, owned and operated by one person. In most cases, these businesses operate as a “**sole trader**”.

Look through the Yellow Pages or a local free business listing posted through your letterbox and you will see lots of examples of people operating as a sole trader in your area. Many traders in the service sector (e.g. hairdressers, gardeners, plumbers and electricians) use the sole trader option, as do people who run part-time or seasonal businesses.

Why is the **sole trader** such a popular form of business organisation? The key reason – it is **simple and cheap** to set up and operate in this way.

**Being a sole trader is the simplest way to run a business:** it does not involve paying any company registration fees; keeping records and accounts are straightforward, and the sole trader gets to keep all the profits.

The sole trader simply registers as being “**self-employed**” with the UK tax authorities.

The profits earned by a sole trader are included in the personal income of the business owner when it comes to calculating and paying income tax and national insurance. Depending on the value of sales achieved, the sole trader may also have to account for VAT.

Don't forget that a sole traders can and do employ other people to work in the business – but most don't.

## Unlimited liability

There is a big downside to operating as a sole trader. It occurs because, in the eyes of the law, **there is no difference between the person running the business and the business itself**. When it comes to chasing money owed by a business, a sole trader has to settle up.

The sole trader is, therefore, **liable** for any **debts** that the business incurs.

If the business takes out a loan or buys goods and services on credit, then the sole trader himself/herself is liable to repay the debt. This is known as the important concept of **unlimited liability**.

As a sole trader is personally responsible for any debts run up by the business, this means the home or other assets owned by the entrepreneur may be at risk if the business runs into trouble.

This sounds like bad news, and for some sole traders the nightmare sometimes becomes reality. Thousands of people become personally bankrupt in the UK each year, many of whom have built up trading debts which they find they are not able to repay.

So why would anyone set up as a sole trader given the risks posed by unlimited liability?  
There are two main reasons:

- (1) Setting up as a sole trader is so easy; setting up a company is (wrongly) perceived as being a bit of a hassle. So simple laziness leaves sole traders at risk
- (2) Some trades have a low risk of failure – where the sole trader buys and sells in cash and does not need to invest significantly

## Incorporation and the protection of limited liability

Incorporation is the creation of a company which then operates as a business. In the vast majority of cases, the type of company created is a **“private limited company”**.

Now, here is the really important part.

**In the eyes of the law, limited companies exist in their own right.**

This means the company's finances are separate from the personal finances of their owners. In the case of a company, the owners are known as **“shareholders”**.

Shareholders may be individuals or other companies. They are not responsible for the company's debts unless they have given guarantees (of a bank loan, for example). However, they may lose the money they have invested in the company if it fails.

In nearly all cases, the most a shareholder can lose (personally) is the money that has been invested in the shares of the company. To use some important legal wording, the liability of shareholders is limited. Hence - the concept of **“limited liability”**.

You should be able to see that the idea of limited liability offers an important protection to a company shareholder.

Consider a company that goes bankrupt owing money to suppliers, taxes to the Inland Revenue and perhaps an amount outstanding on a bank loan. Who is liable for these debts? Is it the shareholders of the company? No – they are protected by “limited liability”. It is the company itself that should have repaid those debts. The company will be liquidated and whatever assets are left will be used to pay off some (not all) the outstanding creditors.

What does it cost to get the protection of limited liability? The answer is – very little. A private limited company can be set up very quickly and the annual administrative costs of a simple company are unlikely to be more than £1,000. That seems a small price to pay for such an important protection offered to the shareholders.

## Comparing private limited companies with sole traders

The main differences between private limited companies and sole traders can be summarised as follows:

	Advantages	Disadvantages
Sole trader	Quick & easy to set up – the	Full personal liability – “unlimited

	<p>business can always be transferred to a limited company once launched</p> <p>Simple to run – owner has complete control over decision-making</p> <p>Owner gets to keep all the profits</p> <p>Minimal paperwork</p>	<p>liability”</p> <p>Harder to raise finance – sole traders often have limited funds of their own and security against which to raise loans</p> <p>The business is the owner – the business suffers if the owner becomes ill, loses interest etc</p> <p>Pay more tax than a company – profits are taxed as income</p>
<b>Limited company</b>	<p>Limited liability – protects the personal wealth of the shareholders</p> <p>Easier to raise finance – both through the sale of shares and also easier to raise debt</p> <p>Stable form of structure – business continues to exist even when shareholders change</p> <p>Can pay less tax – greater tax incentives and allowances</p>	<p>Shareholders have to agree about how profits are distributed</p> <p>Greater administrative costs</p> <p>Less privacy - public disclosure of company information</p> <p>Directors’ legal duties are stricter</p>