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SQE

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2025-26

**BUSINESS
LAW
AND
PRACTICE**

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Key term: sole trader

A self-employed person who is the sole owner of their unincorporated business.

Sole traders may be involved in any trade, business or profession and can be anything from window cleaners and hairdressers to accountants and solicitors. The term 'sole practitioner' is sometimes used for sole traders/proprietors who have a profession (eg a dentist) rather than a trade (eg a shopkeeper).

As an unincorporated business, there is no legal separation between the business and the sole trader's personal affairs/assets. This has the advantage of keeping ownership and management simple. However, the disadvantage to this is that sole traders have **unlimited liability**.

Key term: unlimited liability

Unlimited liability means that a business owner is personally and directly responsible for all debts and liabilities incurred. Therefore, their personal assets (eg any property they own or money held in bank accounts, even if unrelated to the business) will be at risk, and they can be made bankrupt if the business is unsuccessful (see Chapter 6).

For SQE1, it is important to recognise the concept of unlimited liability in the context of sole traders. It is a key disadvantage of carrying on business as a sole trader and its implications can have serious consequences (see Practice example 1.2).

Practice example 1.2

Katrina set up business as a hairdresser several years ago, but the liabilities of the business now exceed its assets by over £100,000. Katrina has savings of £50,000 and a house worth £200,000. The realisable assets of the business amount to £20,000. How would you advise Katrina?

As a sole trader, Katrina will be personally liable for the debts of the business. The business is unincorporated, so does not have its own legal identity (or separate personality). There is no legal distinction between the business and its owner and manager. Therefore Katrina's personal assets will be at risk (including her home) if she is unable to satisfy the debts of the business.

Procedural link: insolvency

When considering liability for the debts of an insolvent business (see key term box in Chapter 6), it is important to know the legal status of the business concerned. There are different rules for individuals/unincorporated businesses and incorporated businesses, and these are considered in Chapter 6.

Although unlimited liability can be a significant disadvantage of being a sole trader, a key advantage is that there are no specific formalities or legal processes required to set up the business. Self-employed people do need to register with HMRC and some sole traders may be required to register for VAT (see Chapter 7). However, the additional costs of forming a company are avoided. In addition to this, unlike companies, there are no onerous ongoing formality, decision-making, filing and disclosure requirements (see Companies below and Chapter 3). This can make being a sole trader more attractive, private and less expensive.

Sole traders pay income tax on their trading profits and capital gains tax on their capital gains (see Chapters 8 and 9). They will usually obtain tax advice when deciding on the type of business medium.

Exam warning

For the purposes of SQE1, it is important to consider the particular circumstances of the client when advising on which type of business medium would be most suitable for their particular needs. You should be able to balance competing factors (eg the importance of limited liability, versus onerous disclosure requirements) in order to advise. Make sure that you read the question carefully (see Practice example 1.3).

Practice example 1.3

Rylan wants to set up his own business as a window cleaner. His funds are modest and his liabilities (see Chapter 5) and financial investment will be low. He is keen to keep things simple and not to incur substantial expense. How would you advise Rylan with regard to the most suitable business medium for him?

Although the benefits of limited liability may be significant for those investing large sums and taking significant risk, it would appear that the costs and administrative burden of setting up a limited company would not be appropriate here. Therefore, in this situation, it would be advisable for Rylan to operate his business as a sole trader.

Partnerships

A partnership is an unincorporated business with at least two owners.

Key term: partnership

An unincorporated business that exists when two or more people 'carry on' a business in common with a view of profit (as defined in s 1 Partnership Act 1890 (PA)).

Partnerships under the PA must be distinguished from limited liability partnerships (see **Limited liability partnerships**, below), which are incorporated businesses.

As with sole traders, although the partners may have employees, they are the owners of the business. They may also be involved in any trade, business or profession.

Revision tip

For the purposes of SQE1, it is important to be able to recognise the existence of a partnership. This is very much a question of fact. It arises when two or more people actually carry on a business in common with a view of profit (see **Practice example 1.4**).

Practice example 1.4

Netta and Duncan are friends. They make and sell cakes in the town where they live and split the money they receive 50-50. They think that, as the arrangements are purely informal and there is nothing in writing, this is not a partnership. Is this correct?

They are mistaken. As Netta and Duncan are 'carrying on a business in common with a view of profit', this is a partnership as defined by s 1 PA. There is clearly agreement between the parties (whether oral or implied by conduct) as to how the business is run.

Therefore, as with sole traders, no specific formalities are required to set up the business. A partnership can arise through oral agreement or through conduct. If the parties are actually carrying on business together with a view of profit, a partnership exists.

Although no specific formalities or legal processes are required to set up a partnership, it is often *desirable* to have a formal partnership agreement, setting out the terms of the partnership (see **Chapter 2**). This is because many of the provisions of the PA will apply, in the absence of an express or implied agreement to the contrary (the so-called 'default provisions').

Many of the default provisions can have undesirable consequences (see **Chapter 2**).

As an unincorporated business, there is no legal separation between the business and the partners' personal affairs/assets. They are therefore personally and directly responsible for all debts and liabilities incurred whilst they are partners (s 9 PA). Their personal assets are at risk, and they may be made bankrupt if the business is unsuccessful (see **Chapter 6**).

Under the PA, there is no separation of ownership and control (s 5 PA). Every partner may act for the purposes of the partnership business and the acts of any one partner may bind the partnership (see **Chapter 2**). This can make management more straightforward than with companies.

As with sole traders, partners do need to register with HMRC and partnerships may be required to register for VAT (see **Chapter 7**). However, the additional costs of forming a company are avoided (see **Companies**, below). In addition to this, unlike companies, there are no onerous ongoing formality, decision-making, filing and disclosure requirements. This can make being in partnership more attractive, private and less expensive.

Individual partners pay income tax on their share of the trading profits and capital gains tax on their share of the capital gains for the partnership (see **Chapters 8 and 9**, respectively). They will usually obtain tax advice when deciding on the type of business medium.

Revision tip

When advising on which type of business medium would be most suitable to a client's particular needs, you should be able to balance competing factors. Two or more people going into business may be more concerned about ongoing costs and formalities than with the implications of unlimited liability. A professional services firm's main concern may be professional negligence claims, for which insurance may be available, making limited liability less important.

INCORPORATED BUSINESSES

This section will explore incorporated businesses – companies and limited liability partnerships. For SQE1, it is crucial that you understand their main characteristics and their advantages/disadvantages.

Companies

A **company** is an incorporated business with separate legal personality and where the owners (members) usually have limited liability. The company

may be limited by shares or by guarantee and can be public or private. These concepts are explored below.

Key term: company

An incorporated business with separate legal personality, where its members can have limited liability.

Unlike sole traders and partnerships, a company is the creation of a legal process and documents must be filed at Companies House in order for a company to be 'born' (see Chapter 3). It is not possible for a company to exist without the involvement of Companies House.

Companies may be involved in any trade, business or profession. They range from very small private companies, with just one director and one member/shareholder, to very large, listed public companies (whose shares are traded on a stock exchange).

Exam warning

For the purposes of SQE1, you need to focus on private companies limited by shares and only those public companies whose shares are not traded on a stock exchange (ie unlisted public companies).

The two key hallmarks of a company are separate legal personality and limited liability. We will look at each in turn.

Separate legal personality

The principle of **separate legal personality** was enshrined in the infamous case of *Salomon v A Salomon and Co Ltd* [1897] AC 22, which held that it was not fraud to set up a limited company in order to create a separate legal person, to avoid personal responsibility for debts. Cases where the court will disregard this fundamental principle and impose personal liability are very rare (*Prest v Petrodel Resources Limited and others* [2013] UKSC 34) and are outside the scope of this book.

Key term: separate legal personality

The company is a person separate from its members/shareholders and directors. As a separate legal person, it can own property, enter into contracts and be a party to legal proceedings (by suing or being sued). It is a key advantage of incorporation and, as an artificial person, it can have perpetual succession (ie it can continue indefinitely).

Unlike sole traders and partnerships, a company is not the agent of its shareholders (not even a one-person company with one director and one member/shareholder). In other words, it acts in its own right and not simply

on behalf of its owner(s). The basic company model distinguishes between the **shareholders/members** and the **directors**.

Key term: shareholders

The shareholders own the shares in the company (see Chapter 3). Sometimes shareholders are referred to as 'members'.

Key term: directors

The directors have general management powers to control what the company does on a day-to-day basis. They run the company.

Directors and shareholders may be the same people, and this can often be the case with smaller companies.

The separation of membership (ownership) and management is a key advantage of incorporation, but it can also be unnecessarily cumbersome for smaller businesses (eg a one member, one director company).

The sale/transfer of a company or any interest in it is also made more straightforward as this can be done through the transfer of shares as an alternative to the transfer of the assets themselves.

Limited liability

The second major hallmark of a company is the potential for **limited liability**. Liability may be limited by shares (more commonly) or by guarantee (usually for non-profit-making entities).

Key term: limited liability

Limited liability means that members have a limit on their liability to contribute towards the company's debts.

Limited by shares - the liability of members (shareholders) is limited to any amount unpaid on their shares (see **Practice example 1.5**).

Limited by guarantee - the liability of members is limited to any amount they promise to pay in the event that the company is wound up (ie when it is brought to an end and ceases to exist - see **Chapter 6**).

Limited liability is a significant advantage of incorporation.

Practice example 1.5

Kobi subscribes and pays for 100 £1 shares in a private limited company. The company is subsequently wound up. What is Kobi's liability?

Kobi will have no further liability as he held fully paid shares. Had payment not been made, or only partially made, he would be liable for the balance.

Advantages and disadvantages of incorporation

Separate personality and limited liability are the most significant advantages of incorporation, but there are also a number of other advantages and disadvantages.

Having a company can be perceived as being more prestigious to both owners and clients/customers. It is the main format for most big businesses and they are recognised internationally.

Companies can grant floating charges, as well as fixed charges. Floating charges are explored further in Chapter 5. The key point to make now is that the floating charge is a more flexible form of security, which can improve the banking facilities available to companies.

Although some expense can be taken up in forming a company, this need not be substantial (see Chapter 2). However, there are onerous ongoing formality, decision-making, filing and disclosure requirements, which can add to administrative burden and legal expense over time (see Chapter 3). The fact that most information kept at Companies House becomes public may not be attractive to those who value commercial secrecy.

Companies pay corporation tax on both their income profits and their capital gains (see Chapter 10). Those setting up a company will usually obtain tax advice when deciding on the type of business medium.

Public and private companies

Finally, it is important to know the key distinctions between private companies and public companies (see Table 1.1). Remember that for the purposes of SQE1, you need to focus on private companies limited by shares and unlisted public companies.

Table 1.1: Private and public companies compared

Private limited company	Public limited company
A company that is not a public company (s 4(1) Companies Act 2006 (CA))	Certificate of Incorporation states that it is a public limited company (see Chapter 3)
May be limited by shares or by guarantee	May be limited by shares
Shares cannot be offered to the general public (s 755 CA)	General public can be invited to subscribe for shares

Table 1.1: (continued)

Private limited company	Public limited company
No minimum capital requirements	Minimum capital requirements - £50,000 (ss 761 and 763 CA) Shares must be at least one-quarter paid up (s 586 CA)
	Subject to more stringent/onerous rules (particularly on disclosure), as public money is involved
	Company may apply for shares to be officially listed for trading on a recognised investment exchange (eg London Stock Exchange or alternative investment market)
	Officially listed companies are subject to additional disclosure rules

Limited liability partnerships (LLPs)

A limited liability partnership is formed under the Limited Liability Partnerships Act 2000 (LLPA). It is a type of incorporated business and is formed by sending form LLIN01 to Companies House.

Key term: limited liability partnership

A cross between a company and a partnership, formed under the LLPA.

An LLP has a combination of the features of both partnerships and limited companies. For example, they are available for persons 'carrying on a lawful business with a view to profit' (s 2(1)(a) LLPA) and every member is deemed to be an agent of the LLP (s 6 LLPA).

However, when registered at Companies House, an LLP has separate personality (s 1(2) LLPA) and members have limited liability/are not directly responsible for its debts (s 1(4) and (5) LLPA).

Like the PA, the Limited Liability Partnerships Regulations 2001 provide provisions that apply between the partners in default of express or implied agreement to the contrary (see Chapter 2). There is therefore more flexibility with regard to management than companies, which have a stricter separation of powers.

Like companies, LLPs may grant fixed and floating charges over their assets. Also like companies, LLPs are subject to ongoing administrative and

reporting requirements. However, a key disadvantage of LLPs is that they are not as well recognised internationally as limited companies.

LLP members pay income tax on their share of the trading profits and capital gains tax on their share of the capital gains for the partnership (see Chapters 8 and 9, respectively). Those setting up an LLP will usually obtain tax advice when deciding on the type of business medium.

SUMMARY

Table 1.2 provides a summary of key information, which should assist in answering SQE1-style questions (remember to always read the question carefully and provide a tailored response).

Table 1.2: Summary: unincorporated and incorporated businesses

	Sole trader	Partnership	Limited company	LLP
Formalities required for creation	No	No - although partnership agreement recommended	Yes	Yes
Incorporated - separate personality	No	No	Yes	Yes
Limited liability	No	No	Yes	Yes
Personal liability for debts	Yes	Yes	No	No
Finance	Can grant fixed charges only	Can grant fixed charges only	Can grant fixed and floating charges	Can grant fixed and floating charges
Management - board structure (separation of powers)	No	No	Yes	No
Stricter formalities/ more onerous administration/ greater expense/ publicity	No	No	Yes	Yes

Table 1.2: (continued)

	Sole trader	Partnership	Limited company	LLP
Status	Less prestigious	Less prestigious	More prestigious	More prestigious - although less recognised internationally
Transferrable shares	No	No	Yes	No

KEY POINT CHECKLIST

This chapter has covered the following key knowledge points. You can use these to structure your revision, ensuring you recall the key details from each point.

- The key different types of business organisation in England and Wales are sole traders, partnerships, companies and LLPs.
- The key types of business organisation can be separated into unincorporated businesses (sole traders and partnerships) and incorporated businesses (companies and LLPs).
- You need to focus on private and unlisted public companies for the purposes of SQE1 and do not need to have detailed knowledge of listed public companies.
- Each type of business organisation has different organisational characteristics and practical implications.
- You need to have good working knowledge of the organisational characteristics and practical implications in order to provide tailored advice to a client on the most appropriate medium for them and the consequences of such a decision. Remember to consider a client's individual circumstances.

KEY TERMS AND CONCEPTS

- unincorporated business (page 3)
- incorporated business (page 3)
- sole trader (page 4)
- unlimited liability (page 4)
- partnership (page 6)
- company (page 8)
- separate legal personality (page 8)
- shareholders (page 9)
- directors (page 9)

- limited liability (page 9)
- limited liability partnership (page 11)

■ SQE1-STYLE QUESTIONS

QUESTION 1

A client wishes to set up business on their own, providing light gardening services. The client is keen to keep things as straightforward as possible and to minimise costs. They do not foresee a substantial capital outlay and they have no plans to take on employees or to borrow money.

Which of the following best describes the type of business medium the client should choose for their business and why?

- A private limited company. This is because there is little administrative burden in setting up and running a private limited company.
- A sole trader. Although limited liability would be of benefit to the client, their needs are straightforward and their investment and overheads would not be substantial. The additional burdens of starting and running a limited company would not be justified.
- A limited company in any event. The benefits of separate personality and limited liability are so great that they outweigh all other considerations.
- A private limited company. The client will be able to separate ownership and control and grant floating charges over the company's assets when they wish to expand the business.
- A public limited company. It will give the client better flexibility to expand and will enable shares to be offered to the public.

QUESTION 2

A client wishes to start up a manufacturing business with a long-standing friend and business associate. The pair plan to buy premises, employ several staff, expand very quickly and trade internationally. In the medium term, the pair will need to borrow considerable funds.

Which of the following best describes the type of business medium the client and their friend should choose?

- A private limited company.
- A partnership.
- A public limited company.
- A limited liability partnership.
- A private company, limited by guarantee.

QUESTION 3

A client holds 10,000 £1 ordinary shares in a private limited company, representing a 5% shareholding. The shares are fully paid and the company is being wound up, with substantial debts.

How much will the client be required to contribute on winding-up?

- The client will not be required to contribute on winding-up.
- The client will be required to contribute 5% of the company's outstanding debt.
- The client will be required to contribute £10,000.
- The client's liability will be unlimited.
- The client will be required to contribute towards the costs of winding-up.

QUESTION 4

A client is a sole trader whose business is in financial difficulty. However, they have substantial personal assets and are keen to ascertain their liability for the debts of the business.

Which of the following best describes the client's liability?

- The business is a separate legal person, and the client will be able to keep their personal assets separate.
- The client will be personally liable for the debts of the business.
- The client's liability will be limited to the amount they contributed to the business.
- The client will be jointly and severally liable for the debts of the business.
- The client will not be liable as the business has not been registered at Companies House.

QUESTION 5

A client is looking to set up a manufacturing business with two friends who are both experienced executives. They plan to expand quickly, have substantial borrowings and appoint over 50 employees. The client is happy not to be involved in the day-to-day management of the business, but he wants to make sure that his liability is limited to his investment. The client may also wish to sell his share in the business on his retirement in a few years' time.

Which of the following best describes the type of business medium the client and his two friends should choose?

- A private company, limited by shares.

- B. A partnership.
- C. A public limited company.
- D. A limited liability partnership.
- E. A private company, limited by guarantee.

■ ANSWERS TO QUESTIONS

Answers to 'What do you know already?' questions at the start of the chapter

- 1) The correct answer was (c) and (d) as these are incorporated businesses, so need to be registered at Companies House. The other two are unincorporated businesses, so do not need to be registered at Companies House.
- 2) The correct answer was (a), (b) and (c). Sole traders and partners have unlimited liability and are personally liable for the debts of the business. Their personal assets are at risk if their business fails. Where a company is limited by shares, shareholders have limited liability and are not personally liable.
- 3) *Salomon v A Salomon and Co Ltd* [1897] AC 22. Although SQE1 does not require you to recall specific case names, this is a seminal case and you need to be aware of its fundamental implications.
- 4) False. In a private company limited by shares, the members/shareholders own the shares and the directors are generally responsible for managing the company on a day-to-day basis.
- 5) False. In a private company limited by shares, it is possible for the directors and the members/shareholders to be the same people. This is often the case with smaller 'owner managed' companies.

Answers to end-of-chapter SQE1-style questions

Question 1

The correct answer was B. Although separate personality and limited liability have clear benefits, they are not the client's main concern, particularly in view of the low capital outlay/risk. Therefore, option C is incorrect. The additional costs of forming and managing a company would be unjustified, making option A incorrect. Option D is incorrect as separation of ownership and control would be unnecessarily complicated, and they have no plans to borrow money, so the ability to grant floating charges is not a concern. Option E is incorrect as a public limited company (plc) would be even less appropriate than a private company; they have no desire to offer shares to the public and would be unlikely to meet the minimum capital requirements.

Question 2

The correct answer was A. The ambitious plans, nature of the business and need to borrow make a private limited company the obvious choice.

There are likely to be significant liabilities and the ability to grant floating charges will be a clear advantage. Option B would be inappropriate as partners have unlimited liability and partnerships cannot grant floating charges. Limited companies are more recognised across the world than LLPs, which makes option D incorrect. A plc would be inappropriate in the short term as there are no plans to offer shares to the public (which makes option C incorrect). Option E is incorrect as a private company limited by guarantee would be more appropriate for a non-profit-making entity.

Question 3

The correct answer was A. The client's liability will be limited to any amount unpaid on their shares, which in this case is nothing. Therefore, options B, C, D and E are incorrect. The client would only be required to contribute on winding-up if the shares were not fully paid. In these circumstances, liability would be limited to the unpaid amount.

Question 4

The correct answer was B. The client's liability will be personal, without limit, as the business is unincorporated and does not have separate legal personality. Therefore, options A and C are incorrect. There is no requirement to register the business at Companies House, so option E is incorrect. Joint and several liability is inappropriate for a sole trader but would be relevant if the client were a partner. Therefore, option D is incorrect.

Question 5

The correct answer was A. The client's key concerns are having limited liability, not being involved in the day-to-day management of the business and having transferrable shares. Therefore, option B is incorrect. The board structure (separation of ownership and control) and ambitious plans make this the obvious choice. There will be significant benefit to limited liability and the ability to grant floating charges. A public company would be less appropriate, although it would be possible to re-register as a public company later. Therefore, option C is incorrect. Companies limited by guarantee are usually non-profit-making entities, so option E is incorrect. Option D is incorrect as limited companies are more widely recognised than LLPs for trading purposes.

■ KEY CASES, RULES, STATUTES AND INSTRUMENTS

The SQE1 Assessment Specification does not require you to know any statutory authorities or specific case names for this topic. However, you should be aware of the implications of the case of *Salomon v A Salomon and Co Ltd* [1897] AC 22. Specific sections of statutes are set out for ease of reference.