



Department for  
Business, Energy  
& Industrial Strategy

# Understanding the Reasons for Incorporation

## Methodology Report

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# Contents

1.	Introduction	5
1.1	Background and context	5
1.2	Purpose of the study	6
1.3	Tasks completed to date	6
1.4	Structure of this report	7
2.	Outcomes of scoping work	8
2.1	Literature review	8
	Institutional influences on incorporation	8
	Conclusions	10
2.2	Qualitative research	10
	Overview	10
	Business formation	10
	Advantages and disadvantages of incorporation	13
	Conclusion	20
2.3	Defining choice attributes	22
3.	Survey design	25
3.1	Survey design	25
	Survey format	25
	Survey structure	25
	Survey content	26
3.2	Sampling strategy	27
	Target population	27
	Sample frame	31
	Sampling method	31
	Sample size	32
3.4	Risks / issues to explore	32
	Omission of prospective business owners	32
	Incorporation as an individual preference versus involuntary choice	33
	Level of knowledge regarding incorporation	33
	COVID-19	33
	Response rate for sole traders	34
4.	Next steps	35
4.1	Testing	35
	Cognitive interviews	35

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Pilot survey and analysis	36
4.2 Implementation	36
4.3 Analysis	36
Econometric analysis	36
Demand estimation	37
Policy analysis & aggregation	38
Case studies	38
4.4 Reporting	38
Summary report	38
Technical report	38
Presentation	39
Peer review	39
5. Work plan	40
References	41
Appendix 1 – Qualitative interviews	43
Research Approach	43
Appendix 2 – Stated Preference Survey	46
Appendix 3 – Peer review comments	47
Review and comments on Methodology Note and Cognitive Draft Questionnaire	47
Ken Willis	47
Newcastle University	47
24th August 2020	47
Appendix 4 – Sample composition and pilot recruitment notes	50

# 1. Introduction

## 1.1 Background and context

In 2019 there were an estimated 5.9 million private sector businesses in the UK. The vast majority are classified as small businesses (approximately 5.82 million have between 0 and 49 employees), with medium-sized business (36,000 have between 50 and 249 employees) and large businesses (7,700 have over 250 employees) accounting for just under 1% of the total number of businesses. Sole proprietorships represent the largest proportion of small businesses (59% of the total), followed by limited liability companies (LLCs) (34%), and ordinary partnerships (7%). In total – across the three types of legal status - approximately 76% of businesses (4.5 million) have no employees.<sup>1</sup>

Reflecting on the profile of small businesses in terms of size and legal status, there is an open question as to why a large proportion of business owners choose to incorporate as LLCs rather than operate as (registered) sole traders<sup>2</sup>. Indeed, there has been rapid growth in the number of incorporated companies in the last decade, and in 2018 – 2019 alone approximately 673,000 new companies were registered. This was an increase of 8.5% compared with the previous year.<sup>3</sup>

In general, the Government has encouraged incorporation by making the process for registering a LLC straightforward with minimal associated financial cost<sup>4</sup>. There are, though, ongoing associated costs such as the additional administrative requirements and loss of financial privacy. From a 'rationale choice' perspective the interpretation would be that business owners expect that the benefits of incorporation outweigh the potential costs. Nevertheless, what may represent the best choice for business owners may not necessarily lead to the best overall outcome for the economy and society.

The current tax regime likely means that lower rates of tax are receipted from the smallest limited companies (via corporation tax) compared with equivalently sized sole traders (via income tax and NIC). Whilst this simply represents a transfer from the public budget to owners of incorporated companies, there may also be an associated deadweight loss, due to the higher costs of setting up and maintaining incorporated businesses. Hence the greater the 'over supply' of incorporated companies, the greater the deadweight loss.

It is important to have a clear understanding of the determinants of this choice to examine policy reform options that may alter incentives for business owners to incorporate, In particular, to understand what the most important demand factors are, and measure and quantify their effect on the rate of incorporation.

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<sup>1</sup> Figures in this paragraph are sourced from BEIS Statistical Release: Business Population Estimates for the UK and the Regions 2019. Available from: [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/852919/Business\\_Population\\_Estimates\\_for\\_the\\_UK\\_and\\_regions\\_-\\_2019\\_Statistical\\_Release.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/852919/Business_Population_Estimates_for_the_UK_and_regions_-_2019_Statistical_Release.pdf)

<sup>2</sup> Incorporation means a company becomes its own legal entity. This requires registration as a limited company at Company House, the UK's registrar of companies and an executive agency and trading fund of the Government.

<sup>3</sup> Companies register activities:2018 to 2019. Available at: <https://www.gov.uk/government/publications/companies-register-activities-statistical-release-2018-to-2019/companies-register-activities-2018-to-2019>

<sup>4</sup> <https://www.gov.uk/government/publications/incorporation-and-names/incorporation-and-names>

## 1.2 Purpose of the study

The aim of the study is to provide evidence on the reasons business owners decide to incorporate or not, including the relative influence of different characteristics of business status (i.e. limited liability company, partnership or sole trader).

Specific objectives of the study include:

- Design a robust stated preference (SP) survey to understand the choice of business owners to incorporate or not;
- Implement the survey with a representative sample of business owners;
- Analyse the factors that influence business owners' demand for incorporation; and,
- Estimate the value of incorporation to business owners in terms of their willingness to pay (WTP) for different aspects of business status.

The scope of the research interprets company incorporation as an individual choice made by a business owner. Adopting this micro-level perspective focuses the research on the driving factors that influence the choice to set up a business as either a LLC or a sole trader. To comprehensively assess these factors requires both a broad contextual understanding of the structure of the economy and intuitional influences on company formation, and a more in-depth understanding of the perceptions and preferences of individual business owners on the advantages and disadvantages of business incorporation.

The outcomes of the research will provide robust WTP estimates for various aspects of business status that are provided by company or partnership incorporation. The findings will present the value that business owners derive from incorporation, and how preferences for different aspects of business status may change if the cost of doing so changed. Understanding how business owners are incentivised to incorporate will provide a much more nuanced evidence base to help policy makers understand the impact of changes in business incorporation due to company registration reform.

## 1.3 Tasks completed to date

- Task 1.1 Project inception – including inception meeting agreeing basic overview of project, communication plan and programme.
- Task 1.2 Evidence & literature review – including existing evidence on the benefits of company incorporation (see Section 2.1) and compiling data and summarising data to assist with the business segmentation (see Section 3.2).
- Task 1.3 Qualitative research – including 20 semi-structured interviews with business owners of both incorporated companies and sole traders (see Section 2.2).
- Task 2.1 Survey design – draft survey developed (see Section 3.1).
- Task 2.2 Sampling strategy – draft sampling strategy developed (see Section 3.2).
- Task 2.3 Respondent panel – respondent panel investigated (see Section 3.3).

## 1.4 Structure of this report

- Section 1 Introduction – introduction to the report, including context for the research, objectives and task completion.
- Section 2 Outcomes of scoping work – findings from the initial research, including literature review, qualitative interviews, and attributes long list.
- Section 3 Survey design – design of the primary research activities, including survey, sampling strategy and respondent panel.
- Section 4 Next steps – outline of next steps for the research, including testing, implementation, analysis and reporting.
- Section 5 Work plan – overview of work plan, including work programme and milestones and deadlines
- References
- Appendix 1 – Qualitative interviews
- Appendix 2 - Stated preference survey
- Appendix 3 – Peer review comments

## 2. Outcomes of scoping work

The scoping work provides the foundation from which the stated preference survey will be developed. It focused on building the understanding of the factors that potentially influence business owner's decision to incorporate or not. The task included a literature review of existing research into intuitional influences on incorporation rates and qualitative research into personal reasons for incorporation, conducted through a series of interviews with a small sample of business owners.

In combination, the literature review and qualitative interviews provide two sources on what influences business owners (both limited liability companies and sole traders), which both reinforce each other and offer different perspectives. The literature review found studies primarily conducting macro level analysis focused on tax incentives and other economic factors for incorporation. The qualitative interviews allowed for more in-depth assessment (of a limited number of stakeholders) supporting the findings in the literature review, but also enriching it with broader understanding of non-economic reasons for incorporating such as lifestyle motivations. Findings from both elements are presented in this section.

### 2.1 Literature review

The purpose of the literature review was to investigate current understanding on the institutional influences on company or partnership incorporation. The identified literature covered several topics that influence incorporation rates including strength of institutions, tax incentives, access to credit and limited liability<sup>5</sup>.

#### Institutional influences on incorporation

It is widely accepted within the literature that institutions play a major role in incorporation rates, as well as the development of capital markets and law enforcement and security (Love, I. et al, 2004). However, it should be noted that while the UK maintains higher rates of incorporation in comparison with other OECD countries (Alanazi, 2020), institutions and legal systems of other OECD countries are developed to a similar level in comparison to the UK. At the institutional level the dominating factors are viewed as the ease of creating a new business in terms of minimal bureaucracy, cost and capital requirement (Alanazi, 2020). Relative to other EU countries the lack of minimum capital requirement may be the most influential, considering - for example - a minimum capital requirement of €25,000 (approximately £22,500) in Germany and €60,000 (approximately £55,000) in Spain (Commercial Law Group, 2014). Moreover, whereas in the UK it takes one day to incorporate online, this process can take up to several weeks in other EU countries.

Tax differentials may also act as incentives to incorporate. As argued by Bratta and Milanex (2019), "Tax differentials across types of employment (employee or sole trader) are likely to have the potential to produce significant labour market effects and tax revenue consequences".

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<sup>5</sup> In order to find the relevant literature, three search engines were employed to access a wide range of material: Google Scholar, ResearchGate and Microsoft Academics. The search terms used include project specific phrases ("reasons for incorporation") and broader terms ("small business taxation") that yield a wide variety of results. Relevant papers were selected and the main focus of review is on the specific topic (i.e. whether the authors analyse the impact of corporate taxes, institutions, etc.), the methodology applied and results (i.e. to identify any consensus findings across the literature).



The literature largely focused on the impact of income and corporate tax in the incorporation decision. Underlying theory suggests that higher corporate taxes would discourage incorporation and higher income taxes would be an incentive for sole traders to take corporate form and pay taxes through the company. The consensus is, not unexpectedly, that corporate tax fluctuations are statistically significant when it comes to business incorporation (Egger et al, 2009; Kneller, 2012; Bruce, 2000; Bruce, 2002; Devereux and Liu, 2016; Liu, 2014). Nevertheless, the approaches in the studies that have examined this vary substantially, and endogeneity is acknowledged by the majority of these authors as one of the key issues (referring to a situation whereby a factor external to the model is influencing both the tax rate and incorporation rate). The relationship between tax reforms and incorporation rates is also investigated, with Devereux and Liu using the 2006 UK tax reform to show that a one percentage point increase in the tax gains to incorporation increases the number of newly incorporated firms by 4.5% (Devereux and Liu, 2016). After controlling for firm size, environment and age, they found this result to be robust.

However, it could also be argued that tax incentives as a prominent factor in the decision to incorporate should not be considered desirable, as “generally, the tax system should strive to be neutral so that decisions are made on their economic merits and not for tax reasons” (Furman, 2008). Regardless, the principle of tax neutrality is difficult to achieve and not always desirable when it comes to policymaking (where they may be used in the context of an explicit intention to boost an economic sector or the general structure of the economy for strategic reasons). Nevertheless, tax disparities might incentivise undesirable behaviour such as the misclassification of employees in order to exploit the most favourable regime (OECD, 2019).

Kneller and McGowan (2011) conducted an empirical analysis using difference-in-difference (analysing several tax reforms in OECD countries between 1998 and 2005). Results were in line with the consensus, but only for the entry stage: the higher the corporate tax, the lower the incorporation rate (Kneller and McGowan, 2011). However, once incorporation takes place, fluctuations in corporate tax do not affect the exit rates. In other words, existing companies respond very little to tax changes. Lastly, besides the divergences between income and corporate tax, Freedman (2014) found that tax reliefs for small businesses investing in R&D or IT expenditure are likely to influence the incorporation decision in the UK.

Additional to tax-related factors, there is evidence in the literature that other economic factors are also important. The two main factors analysed by the literature are access to credit (Devereux & Liu, 2016) and limited liability (Mooji & Nicodeme, 2007; Gordon & Mackie-Mason, 1997). Gordon & Mackie-Mason (1997) conducted a regression analysis controlling for several macroeconomics factors (inflation, log of GNP, etc.) and confirmed the relevance of non-tax factors, especially access to credit. Furthermore, Devereux and Liu (2016) found that incorporation indeed facilitated the access to external financing, despite this effect diminishing substantially as time passes after incorporation.

Regarding limited liability, Devereux and Liu (2016) found that more than the 70% of newly incorporated SMEs in the UK are required to provide personal security for their loans and mortgages (Devereux and Liu, 2016). Hence, despite the financial security for the business owners that limited liability offers, many still have to back investment into their company with their own personal capital. Among other factors that have been analysed in the literature, it is important to highlight the importance of size, as growing business are more likely to incorporate (Love et al, 2004). Furthermore, the sector in which the company operates, and the longevity of the firm have, been found to be statistically significant when included as control variables (Love et al., 2004).

## Conclusions

The reviewed literature primarily investigated institutional influences on incorporation, including the relationship between tax regimes and incorporation rates, and other economic influences such as access to credit and limited liability. The evidence demonstrates that decisions to incorporate are multi-dimensional and several factors that need to be considered, with a consensus on the importance of the differentials between income and corporate tax rates as a driver of incorporation (i.e. the higher the corporate tax, the lower the incorporation rates).

While the findings from the literature review are useful in setting the context within which individuals make decisions, there is a lack of evidence on the factors which individual business owners consider in deciding on whether to incorporate a business, in particular around non-tax and non-economic reasons for incorporation. Such supplemental analysis would provide new insight on this topic and lead to better targeted policies.

## 2.2 Qualitative research

The purpose of the qualitative research was to gain an initial view on the factors that influence the choice of business owners to incorporate their business (or not). This provides a contrast to the insight from the literature review which mainly covers the relationship between institutional factors and incorporation rates.

### Overview

A total of 20 tele-depth interviews were undertaken with business owners – ten with limited liability companies and ten with sole traders. The target sample was primarily aimed at small businesses with one to four employees, across a range of sectors and different locations from across the UK. There was a strong sector mix across the 20 interviews including retail, construction, health/beauty/hairdresser, hospitality and leisure, tradesman, recruitment, entertainment and the motor trade.

The interviews were approximately 30 minutes in duration and followed a semi-structured discussion guide. Topics covered included: the nature of the interviewee's business; the legal status; the reasons for their choice of legal status; the perceived benefits/disbenefits of alternatives; source of advice sought; and more wider aspects of business attitudes and experience (more detail on the sample can be found in Appendix 1).

### Business formation

#### *Employment history*

To understand what brought the interviewees to the point of setting up their own business, participants were asked to briefly explain their working life in terms of the number of jobs they had, what sort of organisations they had worked for and the different roles they experienced.

It is clear from the synopses of both limited liability and sole trader participants that the back stories vary quite considerably. To summarise it includes:

- people who have worked all their lives in a sector before setting up by themselves in the same line of work;

- very young people who trained / did apprenticeships before launching their own business;
- those who have changed direction because of a change in a family circumstance;
- people who were operating under one legal status before changing to another; and,
- some who were employed in one field before following their passion.

This is important context given some of findings that follow on the reasons for incorporation, what advice was sought and the various benefits/disbenefits of different legal statuses

### *Motivations for becoming a business owner*

There was a range of motivations for interviewees wanting to set up their own business regardless of whether they were LLCs or sole traders. For many, it was a case of wanting to be their own boss. Several mentioned they had been working as an employee for several years and wanted to do something for themselves, where they could perhaps earn more and have more spare time to do different things.

*“I didn’t want to work for a boss, I wanted to spend more time with the family and take time off with kids”*

#### *Sole trader, Plumbing & heating*

For others, it was a change in priorities, where a better work life balance could be achieved.

*“I got married and had children, family comes first and this gave me the flexibility to bring up the children”*

#### *Sole trader, Personal health*

For others, it was a case of a calculated risk, making the most of an opportunity but still needing to have courage to maximise the opportunity.

*“We’d just moved house, had a three year old child and money was quite tight. My wife was not keen, but if I didn’t do it, I would always ask ‘what if?’”*

#### *LLC, Auto trade*

And there were those who were just disillusioned from their previous employment and felt they could do just as good a job on their own and enjoy the benefits of a different lifestyle.

*“I was disenchanted with everything being about money and not about service; I’m working at a senior level, where executive search fees are all retained, much larger and in different parts of the world”*

#### *LLC, Recruitment*

### *Understanding of alternative business structures*

There was limited understanding of alternative formal business structures regardless of whether they were LLCs or sole traders. Overall, there were four LLCs who had heard of different legal status options, but three had little knowledge of how they operated.

The other had worked for large corporates previously and was very much aware of the various business structures. He noted that LLPs were more appropriate to accountancy and law firms, and that being in recruitment, this was not the best option for him. There was only one sole trader who had a vague idea about other legal status forms, the rest had not heard about partnerships at all, and did not think they particularly needed to know about them because they were small businesses 'generating enough income to earn a living'.

*"It's not something I looked into as I didn't think it applied to me"*

*Sole trader, Catering/hospitality*

### *Extent of external advice received prior to business formation*

There were differing levels of advice taken by business owners as part of the process of setting up. The advice ranged from a reasonable amount, especially where LLCs were concerned, through to very little, or no advice; the latter being much more common among sole traders. Where external advice was sought by LLCs, it was mostly from accountants, alongside wider advice from family, solicitors, new business advisors and the wider trade.

*"Accountant advised me that I would pay less tax as a company"*

*LLC, Haulage*

There were two quite different experiences at either end of taking advice around the legal status options. The owner of the recruitment LLC felt he had been in business long enough to know the options, and therefore didn't need any external advice. The other, who was in construction said he should have set up as a sole trader if he had been advised correctly. Given the lack of solicitor's advice, LLC owners tended to feel they had little understanding of their legal obligations as company directors. Furthermore, there was very limited understanding of incorporation bar a couple of interviewees who knew a fair amount (i.e. National Insurance contributions, corporation tax and offering shares).

Sole traders hardly took any advice when setting up their own business and often relied on personal, past experience.

*"Dad always worked for himself, so sole trading seemed the way to go"*

*Sole trader, Beauty therapy*

A couple of sole traders had researched online to understand the most appropriate form of business structure for them, one of them also having gone to college to learn about self-employment.

*"It took a bit of planning, I Googled lots of information as research and undertook self-employment courses"*

*Sole trader, Food services*

## Advantages and disadvantages of incorporation

### **Reasons and advantages of being a limited liability company**

There was wide a variety of reasons stated for opting for LLC legal status, but by and large they were offered as main and secondary reasons, as well as reasons which were much less frequently mentioned and therefore not as important.

#### *Main reasons*

There were four key reasons for choosing LLC as the preferred legal status:

- 1. Greater protection if the business failed. The fact that this structure enabled the company to have a separate legal identity was seen as a significant benefit and provided reassurance that should any debts be incurred by the company, the business owner's personal assets would be safe.

*"It's nice to know that if things went belly up, it would be separate to the house"*

#### *LLC, Haulage*

- 2. Maximising tax-free income (i.e. dividends). Paying a smaller amount of tax enabling more opportunities to take dividends from company profits was another key driver for having limited liability status.

*"I took advice about not paying much tax, taking dividends out of company profits, whilst keeping plenty in the business"*

#### *LLC, Motor trade*

- 3. A related factor is that an LLC provides the opportunity for spouses to be directors, which means they too can take dividends out of the business, as long as it is in profit.

*"I keep to the PAYE limit and then draw dividends, and my wife also takes dividends as appropriate"*

#### *LLC, Dental health*

- 4. Lowering tax and National Insurance liabilities. Similar to the above point but slightly different is that interviewees used the minimum tax and national insurance thresholds to allow more headroom for dividends.

*"Taking a minimum wage and topping up with dividends is the most tax savvy way to progress"*

#### *LLC, Retail (wine merchant)*

#### *Secondary reasons*

There were a variety of secondary, but still important reasons, why interviewees chose the limited liability business structure.

- Business reputation and professional status. This was a key issue particularly in the business to business environment, where limited companies were providing business services to other companies, as well as dealing with suppliers.

*“Credibility and people’s perceptions are important when you’re opening accounts with new companies and suppliers; it makes everything more hassle free”*

*LLC, Motor trade*

- Opportunities to grow the business. Some were interested in growing their business beyond where it was currently; this included both premises and more employees.

*“Moving from sole trader to a limited company has turned us into a proper company, which will help us grow the business”*

*LLC, Construction (fencing)*

- Easier to access business finance. This was especially important in the construction business where it was found to be easier to secure bank loans and better rates of interest as a limited company.

*“Suppliers are slightly less inclined to offer credit if you’re not limited”*

*LLC, Construction*

- Making easier to secure contracts. Again, this was more relevant to those in construction where being a limited company made it more likely to win contracts.

*“I’ve won three quite big building contracts and it’s being a limited company that has swung it”*

*LLC, Construction*

### *Other reasons*

There were also some infrequently mentioned and less relevant reasons for having limited liability status. These included selling the business or transferring ownership, providing a company pension, and securing the company name or stopping others from using it. In the case of the latter, there was one company where two separate firms tried to use a similar name. And on the company pension, there was one who intended to make use of this facility once a trust deed had been lifted.

It is also worth noting that a former sole trader was unable to maintain that position from an HMRC (IR35) single supplier client perspective. He was told that unless he changed legal status, his customer could no longer offer him any work.

The issue of raising finance that allowed the company to issue shares was not mentioned at all as a reason for taking on limited liability status.

### **Disadvantages of being a limited liability company**

Factors which could be perceived as disadvantages were typically seen as part of running a business, such as:

- Potentially complicated to set up;
- Have to maintain accounts/report to Companies House;
- Accounting procedures and bureaucracy e.g. VAT, PAYE, tax returns;
- Costs of external advice;
- Ownership; and,
- Public records.

None of the above were seen as a disadvantage on their own, just things that had to be done as a part of business, and while sometimes a pain, these factors were often perceived in a positive light.

*“It keeps it all above board and is a big help, especially if you’re a successful business”*

*LLC, Motor trade*

The main disadvantage was all the bureaucracy and paperwork that was required for submitting reports and accounts.

*“You can’t just walk away, you’ve got to file all the accounts; it’s not really a headache, it’s pain that goes with the territory”*

*LLC, Construction*

Companies relied on accountants to deal with HMRC and filing accounts with HMRC, and most of the time this was also the case for other accounting procedures and bureaucracy, such as VAT and PAYE.

*“My accountant does it all, he’s a personal friend, he takes responsibility and I know exactly where I am”*

*LLC, Motor trade*

There were two or three LLCs where employees had taken accountancy courses, which enabled them to do their own PAYE and VAT. Although quite a daunting experience at first, it was a means of reducing costs and keeping on top of the finances. Accountants would then check the accounts before filing with Companies House and dealing with HMRC.

*“My mum does the finances, bookings, payments and invoices; she does everything”*

*LLC, Entertainment*

Costs of external advice was mentioned as a downside because it was expenditure, but overall interviewees felt they got value for money from their accountants, which took the worry away from dealing with HMRC, and also enabled owners to concentrate on customers and sales.

*“I’m paying for a good service, so I feel I get value for money”*

*LLC Construction (fencing)*

Accountants also played a role at the beginning, this helped to avoid any potential complications as part of setting up the businesses, and as such, this was not an issue.

*“My accountant took care of all that side of things”*

*LLC, Retail (wine merchant)*

Having company accounts on public records was not an issue for most, although there was one who did not like the idea of accounts being on ‘public display’. One was actually quite positive about this point.

*“...it’s good that people can access your accounts, it helps to make sure things are done correctly...”*

*LLC, Construction*

### **Reasons and advantages of being a sole trader**

Most interviewees knew little to nothing about setting up a sole trader business. As such, they had little idea about the pros and cons, and the decision to set up as a sole trader was more often driven by lifestyle factors than rational business and economic features. It is therefore fair to say that business structure factors had little influence in becoming a sole trader. These factors included:

- Keeping all the profits;
- Ease of set up;
- Low start-up costs;



- Maximum privacy – no need to provide report and accounts; and,
- Easy to change business structure.

The only perceived advantage from the above list of attributes was the ease of setting up the business.

*“It was fairly easy, I did most of it online”*

*Sole trader, Beauty treatment*

Much more relevant reasons for setting up as a sole trader were lifestyle factors. One of the key factors is that some just wanted to be their own boss.

*“I don’t have to answer to anyone but myself; I can do all I want, when I want, don’t have to work weekends”*

*Sole trader, Beauty treatment*

Another key factor was that some wanted a better work life balance when their children were growing up.

*“...very simple, I started a family and running a restaurant kitchen doing late hours was not conducive to bringing up small children”*

*Sole trader. Catering & hospitality*

For others, being a sole trader was the most relevant structure because of what the business did, or did not involve.

*“I didn’t require assets and the hire of a facility, so there wasn’t need of being a limited liability company”*

*Sole trader, Leisure*

Another factor was to free up time for other prior priorities.

*“I can go on holiday when I want to”*

*Sole trader, Beauty treatment*

And there were some who just wanted a bit of financial freedom, although this was not necessarily about making lots of money.

*“I didn’t want to earn a fortune, just enough to be comfortable to help pay off the mortgage and pay for holidays”*

*Sole trader, Personal health*

A couple of interviewees had set up their business after being made redundant, one as recently from the start of the Covid-19 lockdown.

*“I got made redundant, but wanted to stay in beauty treatment, I had experience and had built up some clients, so decided to do it on my own”*

*Sole trader, Beauty treatment*

### **Disadvantages of being a sole trader**

Overall, sole traders did not see any disadvantages to this form of business structure, There was some concern around lack of protection and unlimited personal liability for business debts, but this was usually offset by interviewees feeling that they had the sufficient insurances to protect them.

*“I have insurance in place like public liability, and I’ve got my professional indemnity...any issues are only going to impact on one individual”*

*Sole trader, Leisure*

Furthermore, interviewees were not very concerned about various financial aspects such as tax efficiency and keeping all the profits, mainly because they felt too small to bother with the extra bureaucracy and administrative requirements,

*“I’m not looking to expand, so keeping all the profits is not an issue...”*

*Sole trader, Beauty treatment*

Similarly, paperwork was not a perceived as a disadvantage as most did not have to worry about VAT and PAYE, mainly because they did not hire employees and they were below the VAT threshold.

*“I just pay the tax bills, I operate on a self-contract basis and come in below the VAT threshold”*

*Sole trader, Plumbing & heating*

Finding it harder to take breaks was an issue for some more than it was for others.

*“I was working before, so while a challenge, it’s not enough of a disadvantage for me not to do it (run my own business)”*

*Sole trader, Beauty therapist*

Other potential disadvantages of being a sole trader like being less attractive to clients and finding it more difficult to secure funding were a non-issue for most people. Again, this was mainly about the size of the business.

*"I'm just a small business, so these are not an issue to me"*

*Sole trader, Retail (headwear)*

### **Expectations of running a business**

The majority of both limited liability companies and sole traders felt that their expectations of running their own business had at least been met, and in many cases been exceeded. Indeed, interviewees' reasons for setting up their businesses had largely been borne out, and most were more than satisfied with the way things had turned out.

*"We've achieved something phenomenal; we've started from scratch and now we have a really good business which gives us a good standard of living and nice holidays..."*

*LLC, Construction (fencing)*

*"I've achieved my ambitions. I'm self-sufficient, the mortgage is paid off and been able to put my kids through university"*

*Sole trader, Plumbing & heating*

### **Concerns about running a business**

The concerns that interviewees had in setting up their own business were relatively minor compared to the perceived benefits. Where there were concerns, they were usually short lived and never manifested. The over-riding concern for both LLCs and sole traders was making the business a success.

*"The fear is, I've got to make a go; there's no turning back. The first two months kept me awake, it started to get easier...12 months I broke even and in the second year I made a profit"*

*LLC, Motor trade*

*"Whether I would get enough jobs, but this was no issue after a couple of months"*

*Sole trader, Plumbing & heating*

For both business types, this was mitigated by two things: personality type and building up clients from previous employment.

*“Could have turned to dust, I’m an optimist but also a realist...but it is always a worry”*

*LLC, Retail (wine merchant)*

*“...built up a community, so we already had customers”*

*Sole trader, Leisure*

And for sole traders, an added mitigation factor was that it was not the main income because their partner was in a well-paid job.

*“My wife has a highly paid job, so it wasn’t really an issue”*

*Sole trader, Leisure*

There were other more minor concerns included keeping records, VAT and PAYE up to date. However, these concerns were not realised because business owners had accountants to manage these issues and, as such, there was no need to feel anxious.

*“...no concerns apart from doing self-assessment, but my accountant takes care of that, so there’s no need to be concerned”*

*Sole trader, Retail (headwear)*

One sole trader was concerned about not being entitled to holiday or sick pay. Another was concerned about his own and his clients’ safety. But he was reassured by a clean safety record and the company’s testing procedures. As such, these concerns had subsided.

*“What if something really bad happens to myself, a limited company has the advantage of being able shield the business”*

*Sole trader, Leisure*

## Conclusion

The qualitative research investigated business owner perceptions of incorporation through semi-structured interviews. It both supports and supplements the findings from the literature review. As would be expected a range of opinions were expressed, in particular around the advantages and disadvantages of a limited liability company or being a sole trader. These findings feed into the development of the long list of attributes for the choice experiment and are listed below.

## **Reasons and advantages of being a limited liability company:**

### *Primary reasons*

- Greater protection if the business failed;
- Maximising tax-free income (i.e. dividends), such as the opportunity for spouses to be directors and take dividends out of the business;
- Lowering tax and National Insurance liabilities;

### *Secondary reasons*

- Business reputation and professional status;
- Opportunities to grow the business;
- Easier to access business finance;
- Making easier to secure contracts.

### Disadvantages of being a limited liability company:

- Have to maintain accounts/report to Companies House;
- Accounting procedures and bureaucracy e.g. VAT, PAYE, tax returns;
- Costs of external advice;

## **Reasons and advantages of being a sole trader:**

Economic and administrative issues were not found to be influential (e.g. keeping all the profits; ease of set up; low start-up costs; maximum privacy – no need to provide report and accounts; and, easy to change business structure). Rather, lifestyle motivations appear more important than more standard business factors as a rationale for choosing sole trader status:

- Be their own boss
- Better work life balance,
- Being the ‘most relevant’ structure based on business activities;
- Personal priorities (‘going on holiday when they want’); and,
- Financial freedom.

### Disadvantages of being a sole trader:

- Lack of protection and unlimited personal liability for business debts.

A careful balancing of which attributes are included, and which are omitted will need to be achieved. Once the survey is designed, the cognitive interviews will be a crucial part of the testing process to achieve this. Notably, the research also indicated that people are not always particularly knowledgeable on the incorporation process, and what benefits and costs the business structure brings relative to being a sole trader. This is a factor which must be

considered further in the survey design, which must present enough information for respondents to make an informed and meaningful decision.

### 2.3 Defining choice attributes

Table 2.1 summarises the range of characteristics of business status which potentially influence a business owner's decision to incorporate or not. The list of characteristics is compiled from the findings of the literature review, previous research for HMRC (Ipsos MORI, 2014), and qualitative interviews and are either directly observed or inferred to possibly influence the business formation decision. The characteristics are structured according to a set of component factors to further explore their materiality through the survey testing phase.

Notably, the list of attributes presented here will subsequently be refined to a list of attributes that will feed in to the DCE. This will happen through multiple iterations of testing and review including feedback on this methodology report. Therefore, it is not expected that the final DCE will necessarily consist of all the initial attributes listed here in their current form.

**Table 2.1 Characteristics which influence decision making**

Characteristic	Factor	Description
Legal status	Limited liability protection	Incorporation offers protection from business liability for the business owners, or shareholders. Limited liability is a form of legal protection for shareholders and owners that prevents individuals from being held personally responsible for their company's debts or financial losses. However, it also comes with certain legal requirements on business owners.
Financial	Tax regime	Incorporation can lower tax and NI liability. Limited company profits are subject to UK Corporation Tax, which is currently set at 19%. As well, National Insurance Contributions (NICs) can be minimised as limited company dividends are not subject to NICs.
	Access to finance	An incorporated company can have preferable access to finance, such lower interest rates to a sole proprietorship and greater lines of credit. Incorporation also makes it possible for businesses to raise funds by selling shares.
	Cost/Fee	Cost / Fees associated with registering as a limited liability company.
	Company pension	Incorporated companies can treat pension contributions as an allowable business expense.
Commercial	Supplier criteria	Some larger companies are more comfortable hiring a registered company, rather than a sole proprietor to do the work (e.g. in the construction sector).
	Reputation / business credibility	An incorporated company, as compared to a sole proprietorship, is generally afforded more credibility as a growing business.
	Recruitment	Incorporated companies may have an advantage at attracting qualified applicants due to perceived credibility.
Ownership	Shared ownership	In an incorporated company portions of a company, divided into shares of stock, can be bought, or sold without having any effect on the underlying structure or function of the company.
	Transferability	An advantage of incorporation is the ease of transferability of ownership, as shareholders can simply buy and sell stock of the company.

	Privacy	An incorporated company may aid personal anonymity of the business owner, but also requires publicly available financial reporting.
Administrative	Bureaucracy	Incorporated companies have legal requirements to submit reports and accounts, which may necessitate external advice.
	Securing the company name	Incorporation under a company name can help secure the name as a trademark.

In addition to the factors of business status described in Table 2.1, the research will also consider attitudinal and other individual motivating factors which may influence the decision on business formation, for example (from the qualitative research):

- Desire to be their own boss;
- Better work life balance;
- Ability to focus on personal priorities ('going on holidays when the want');
- Attitudes to risk; and,
- Financial freedom.



## 3. Survey design

The stated preference survey is the primary data collection tool being implemented in the study. This section covers the survey design, including format, structure and content, the sampling strategy, including target population, sample frame, method and size, and risks and issues to explore when conducting the research.

### 3.1 Survey design

#### Survey format

A variety of stated preference formats that can be considered for the choice task aspect of the survey (e.g. conjoint analysis, best-worst scaling, paired comparisons, discrete choice experiment, contingent valuation). However, the theoretically valid methods for estimating WTP or WTA are the discrete choice experiment (DCE) and contingent valuation (CV). These methods – if applied appropriately – meet certain criteria concerning the measurement of economic value. In particular the choices presented to respondents should (a) include at least one feasible option (usually the ‘baseline’ or no change/status quo), where ‘feasible’ means within the respondent’s budget constraint, and (b) not force respondents to make a costly choice when they would be happy with the baseline, or for any reason cannot afford to pay.

The discrete choice experiment (DCE) format is expected to be the appropriate approach to use in this study. In simple terms this would represent the choice on business formation in terms of a set of attributes that describe the business status (e.g. liability, tax implications, protections, fees, etc.). Respondents answer a series of repeated choices with 2-3 options in each that offer varying combinations of the attribute levels (i.e. characteristics for business status). Typically, 6-8 repeated choices are the optimal number, accounting for the preference information generated and avoiding respondent fatigue. The combination of attribute levels shown in each choice option is determined by a statistical experimental design.

#### Survey structure

The survey will be developed following good practice guidance. The target time to complete the survey will be approximately 10 - 15 minutes, which is a reasonable timescale in terms of respondent attention and avoiding survey fatigue. The typical structure and content for a stated preference survey is as follows:

- A. Screening and sample representativeness – upfront questions to ensure the respondent profile is consistent with the sampling frame;
- B. Experience, perceptions and attitudes – ‘warm-up’ questions that introduce the respondent to the survey topic (i.e. business status and formation) and collect relevant contextual information (nature of the business, business age, legal status, advice received etc);
- C. Choice task(s) – the stated preference choice questions (e.g. choice experiment);
- D. Follow-ups – a sequence of questions that probe respondents’ motives and understanding of the choice tasks in order to assess the validity of their responses (e.g.

testing for certain response biases) and other supplementary questions to collate supporting evidence (e.g. views on benefits/disbenefits of incorporation); and,

- E. Other profile information – a final set of questions to obtain additional business profile information (e.g. turnover) and the socio-economic and demographic characteristics of the business owner (to be used in the data analysis for segmenting results and validity testing).

### Survey content

In general, the content of the survey should satisfy one of three criteria:

- **Help to understand respondent characteristics** - assures the survey sample can be tested for representativeness, and that results can be presented for different segments of the population.
- **Provide evidence on the value of the good being tested** – the choice experiment, reflecting the attributes of the good in question.
- **Support interpretation of the results** – questions which provide supplementary information or context to the results, such as respondent motivations and validity testing.

These elements reflect the purpose of conducting the survey. Questions which do not address one or more of them are likely unnecessary to the study.

The DCE component of the survey presents the simulated choice setting for respondents. In order for the research to generate reliable and robust results, respondents need to (a) understand the choices they are being asked to make, and (b) believe that their responses will be consequential (i.e. that their views matter). These are the basic requirements for avoiding hypothetical bias in the survey results.

The main elements of the simulated choice setting are:

- **Define the good** - To conduct the choice experiment the survey must describe the 'good' in question, in this case, 'incorporation', so that the respondent is familiar with what they are being asked to value and understands the benefit that they would receive (or forego) based on their decision.
- **Define the change** - The choice experiment must present options which contain a 'change' in the provision of the good relative to a price point to elicit an implied valuation from the respondent. In general, a change could be defined in terms of the level of provision of the good in question; however, incorporation is a binary good, either the business is incorporated (i.e. a limited liability company) or it is not (i.e. a sole trader). As incorporation can be understood as a good with constituent attributes which make up its overall value to the consumer (i.e. business owner), it is these attributes (as identified in Section 2) which are changed within the choice experiment to elicit a valuation based on their relative importance, and the overall value placed on incorporation.
- **Intuitive framing** – The choice should be made within the relevant institutional framing, in this case, the legal status of the business, other a limited liability company or a sole trader.
- **Payment vehicle** – To estimate value the choice must contain a 'price' element which is a means to induce value by making the respondent trade-off differing levels of provision

for attributes vs. income to business owners. The principle candidate is the business registration fee.

*Appendix 2 contains the draft survey following the pre-pilot cognitive testing.*

## 3.2 Sampling strategy

*Note that an updated sample composition note is attached in Appendix 4.*

The purpose of the sampling strategy is to define the target population, sampling method, survey mode and sample size for the implementation of the stated preference survey.

### Target population

There are several potential sources from which to identify the target population, each with different coverage. These are summarised in Table 3.1. The BPE has been chosen as the preferred source as it is the only one containing both companies and sole traders and can also be broken down by business size.

**Table 3.1 Business population sources**

	<b>FAME</b>	<b>BPE (from IDBR)</b>	<b>Companies house</b>	<b>ONS (IDBR)</b>	<b>HMRC</b>	<b>Market Location</b>
<b>Contents</b>	Raw data from Companies House, with some added value e.g. company size.	Estimate number of businesses in the UK private sector, includes sole traders. Includes breakdowns by business size.	All registered companies, irrespective of tax status.	Number of VAT and/or PAYE based local units by legal status, region and employment size bands	From company tax returns (incorporated and unincorporated)  From Self-assessment tax returns (incl. sole traders / self-employed)	B2B database.
<b>Gaps</b>	Excludes sole traders.	Count of companies derived from IDBR therefore assumes all companies are above VAT and/or HMRC thresholds.	Excludes sole traders, no size data.	Consider just companies that are registered for VAT and/or PAYE.	Taxpayer data cannot be broken down by business size for incorporated businesses.	

		Therefore, possibly <sup>6</sup> undercounts companies.				
<b>Structure</b>	Flat unstructured but can create ownership structures.	Aggregated to Enterprise level, which is the lowest level where a combination of legal units has a degree of autonomy. It therefore reports fewer companies.	Flat – unstructured.	Aggregated to enterprise level.		
<b>Other issues</b>	Can be difficult to manipulate and has some gaps in data.	IDBR can be 1.5 years out of date.	Data not 'linked'.	IDBR can have a time lag of 1.5 years.	Time lag – approx. 1.5 years  Data appears to (broadly) corroborate BPE estimate for sole traders	Questions on age, source, and method.

The target population for the survey is small business owners. These are the individuals that face the choice of whether to incorporate their business and operate as a LLC or to set-up as a sole trader. Table 3.2 summarises the profile of the target population, reporting 2019 Business Population Estimates (BPE)<sup>7</sup>.

<sup>6</sup> Although this may not be the case if the company director pays themselves a salary as well as takes income out as dividends.

<sup>7</sup> Population estimates are sourced from the BPE.

**Table 3.2 Target population**

Size (no. employees)	No. businesses (% total)	No. owners (% total)	No. sole traders (% total)	No. companies (% total)
0	4,457,820 (76%)	3,935,000 (89%)	3,251,425 (93%)	909,955 (46%)
1	143,135 (2%)	175,000 (4%)	111,640 (3%)	0 (-)
2-4	751,205 (13%)	176,000 (4%)	91,430 (3%)	619,010 (31%)
5-9	261,045 (4%)	67,000 (2%)	26,115 (1%)	215,860 (11%)
10-19	138,320 (2%)	35,000 (1%)	7,610 (<1%)	120,195 (6%)
20-49	72,975 (1%)	27,000 (1%)	1,695 (<1%)	65,730 (3%)
50-99	23,530 (<1%)	8,000 (<1%)	165 (<1%)	22,560 (1%)
100+	19,740 (<1%)	23,000 (1%)	50 (<1%)	19,445 (1%)
Total	5,867,770	4,448,000	3,490,130	1,972,755

Source: Business Population Estimates for the UK and Regions 2019, 10th October 2019 (UK private sector).

The BPE highlights that approximately 91% of UK businesses fall within the 0-4 employee business size range. For sole traders this increases to approximately 99%. Around 78% of LLCs are sized 0-4 employees, with a further 11% in the range 5-9 employees and 6% in the range 10-19 employees – representing approximately 95% of all companies. According to the BPE data, the estimated number of business owners across these sizes is over 4 million.

Available BPE data for the profile of UK businesses across industry sections<sup>8</sup> does not distinguish between legal status; hence data must be interpreted as indicative for the sampling strategy. Table 3.3 provides the profile according to employment (people working for a business, including owners and partners).

<sup>8</sup> 1-digit SIC code.

**Table 3.3 Profile of small businesses (<50 employees) by industry section**

	None	1-49 employees
Agriculture, Forestry and Fishing	9%	10%
Mining and Quarrying; Electricity, Gas and Air Conditioning Supply; Water Supply; Sewerage, Waste Management and Remediation Activities	2%	3%
Manufacturing	2%	5%
Construction	11%	8%
Wholesale and Retail Trade; Repair of Motor Vehicles and Motorcycles	2%	6%
Transportation and Storage	6%	4%
Accommodation and Food Service Activities	1%	9%
Information and Communication	6%	6%
Financial and Insurance Activities	2%	3%
Real Estate Activities	5%	9%
Professional, Scientific and Technical Activities	8%	7%
Administrative and Support Service Activities	4%	5%
Education	15%	5%
Human Health and Social Work Activities	5%	7%
Arts, Entertainment and Recreation	10%	4%
Other Service Activities	12%	9%

Source: Business Population Estimates for the UK and Regions 2019, 10th October 2019 (UK private sector). "None" includes sole proprietorships and partnerships with only a self-employed owner-manager(s) and companies with one employee (i.e. employee director).

According to Table 3.3, small businesses are spread across all industry sectors, although almost half of no employee businesses (~48%) are observed in the construction, education, art, entertainment and recreation, and other service activity sectors. For small businesses with employees (1-49), the greatest proportion are in the aggregate service sector (~55%).

## Sample frame

The sample frame population is the source from which the stated preference survey sample will be drawn. The Longitudinal Small Business Survey (SBS)<sup>9</sup> conducted on an annual basis by BEIS draws its sample from a combination of sources, including an ongoing panel of respondents who have responded to previous versions of the SBS, the Inter-Departmental Business Register (IDBR) for registered businesses (PAYE and VAT), and commercial databases for unregistered businesses (Dun & Bradstreet).

The Companies House User Panel has been made available for this research, which provides the basis for sampling LLC owners. The panel is comprised of approximately 4,500 users of Companies House services (incorporation, filing, searching for company data), of which approximately 2,131 are company directors<sup>10</sup>.

Commercial databases (MarketLocation, Dun & Bradstreet) represent the primary source for sampling sole traders. These report significant coverage of UK private sector businesses (in region of 1 million) with the ability to construct a sample based along characteristics such as business type, location, number of employees, years established. The coverage of the commercial databases also provides a secondary source for sampling LLCs if required.

## Sampling method

The basis of a stratified sampling approach is summarised in Table 3.4. This specifies five distinct sub-populations (strata or segments), based on company size. The main rationale for a stratification based on company size is that the choice on the part of a business owner to opt for LLC status may in part be driven by a business planning strategy that envisages growth of the company and increased number of employees. Hence the materiality of factors related to – for example - transfer of ownership or recruitment may differ across segments; a sub-sample approach therefore provides the basis for testing for such effects (e.g. vs LLCs with zero employees).

**Table 3.4 Proposed sample stratification**

Segment	Representation (Table X)
Sole trader; 0 employees	Approx. 94% of all sole traders
Sole trader; 1-4 employees	Approx. 6% of all sole traders
Company; 0 employees	Approx. 46% of all LLCs
Company; 1-4 employees	Approx. 32% of all LLCs
Company; 5-9 employees	Approx. 11% of all LLCs

A random sampling approach will be applied within each sub-population. This treats each segment as an independent sample, meaning separate study results will be provided for each

<sup>9</sup> <https://www.gov.uk/government/collections/small-business-survey-reports>

<sup>10</sup> Source: Companies House User Panel data provided August 2020. Note the proportion of panellists who 'founding' company directors is not capture in the current User Panel data.

sub-population. Aggregate results (overall business population) will be estimated by weighting by the relative shares of each segment.

Random sampling within each segment should ensure a reasonable representation across industry sections, although as noted above the exact profile of businesses by legal status is unknown. Available BPE estimates also do not provide a breakdown by number of employees. The approach therefore will be to ensure that each sub-population has a good mix of respondents by industry section. A potential option to consider (post-pilot survey) is the use of 'soft' quotas so that any single industry does not exceed a certain proportion of the overall sample.

### Sample size

Based on current expectations for the development of the DCE component on the stated preference survey, a minimum of 250 respondents per sampling strata is expected to give reliable estimates in terms of the precision of results (e.g. WTP estimates). This factors in the potential for heterogeneity in business owner preferences within segments (strata) and the requirement to use appropriate choice model estimations in the econometric analysis to test for these effects. The precision of the estimation results will, though, be improved if larger samples can be achieved for each segment, with a more ambitious target being in the region of 350 respondents per sampling strata. This is largely dependent on the response rate that can be achieved from the available samples (and impacted by factors such as method of recruitment, survey length, incentives for completing the survey, as well as the time available for fieldwork).

The overall sample size is therefore in the range 1,250 (minimum) to approximately 1,750.

## 3.4 Risks / issues to explore

In designing the research, several aspects need to be considered and tested to ensure the analysis can produce reliable evidence for policy use. These risks and issues have emerged from the initial research activities and experience from previously conducting similar research activities. The main issues identified are presented in this section.

### Omission of prospective business owners

A key consideration in defining the target population is whether the exclusion of prospective business owners is a critical omission. However, in practical terms it is not possible to determine who prospective business owners might be – i.e. individuals who may (or may not) form a business and then have the choice of opting for either LLC or sole trader status. Moreover, there is no strong prior reason to expect that the overall profile and preferences of prospective business owners would differ substantially from current business owners – i.e. the population of current business owners are the best representation of population of prospective business owners<sup>11</sup>.

It is also important to reflect on the main aim of the research, which is to understand the value of incorporation. For the most part, this is an experienced benefit and current business owners of LLCs are those currently directly deriving this benefit, whilst sole traders have opted (either knowingly or unknowingly) not to. The target population as defined in relation to current

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<sup>11</sup> The one caveat to this is the potential for a fundamental / structural change in the types of individual and reasons for setting a business due to the effects of the COVID-19. However, it is likely too early to understand the scale and materiality of any potential effect in this regard.



business owners, therefore comprises of the individuals that can be observed as participating in the 'market' for incorporation – which is the basis of the simulated choice that will be developed in the DCE component of the stated preference survey.

### Incorporation as an individual preference versus involuntary choice

The assumption that choices based on individual preference are the best representation of business formation, rather than for example exogenous factors such as economic cycles driving an involuntary choice, must be considered. Some people may not be able to secure income unless they have a registered company, such as when a potential client requires it or other employment opportunities are not available. These factors could also be linked to the wider economic context, and therefore apply systematically across the population.

It is not clear whether a sample chosen from the respondent panel would accurately reflect this segment of business owners, especially in the still emerging context COVID-19 related economic impact. However, respondents who fall into this category can be identified through the survey design, and by sampling a wide range of business owners with varied experiences the effect should be picked up if distinct. If this segment is identified, further analysis can develop a profile of this subset of business owners and explore any systematic effect on their preferences.

The survey design includes questions to test this effect.

### Level of knowledge regarding incorporation

It is not clear that business owners are always well informed on the advantages and disadvantages of incorporation when making the decision to do so or not. As with the general population, there will be heterogeneity in the sample of business owners, with a possible wide range of knowledge on incorporation. Thus a challenge lies in providing enough information for business owners to make a considered response based on neutral provision of information, while not leading them to a constructed preference by providing more information than they would have considered in their 'real life' decision to incorporate or not. Generally, respondents should at least be knowledgeable enough to understand the trade-offs that they are making in order to reach informed and meaningful decisions, based on their preferences and the perceived relative value of different choices.

The survey design includes questions to test this effect.

### COVID-19

Currently an added consideration is the impact of COVID-19 restrictions on the research. It is difficult to pre-judge whether respondents' views obtained in such unprecedented circumstances in most peoples' lives will be reliable for use in 'normal' policy analysis circumstances. Moreover, the full impact has not likely been felt yet, particularly in terms of the effect on business revenue and what this might mean for business owner priorities over the longer term, especially if there is a prolonged economic downturn, and subsequent restructuring of the economy and impact on incorporation rates.

Our initial research will focus on reasons for the business owners' current choices (i.e. incorporation or not) and hence the impact of COVID-19 in this context should be minimal. By the time of the main survey research the economic impacts may be clearer, removing some of the uncertainty that would influence respondents' preferences. Testing of these issues as the

project progresses will help ensure that the research is appropriately responsive and includes mechanisms to test and validate the survey results.

The survey design includes questions to test this effect.

### Response rate for sole traders

There is a risk to the research from not achieving a sufficient response or completion rate from both company directors and sole traders due to them being 'time poor', perceived sensitivities in the survey question, or a general lack of interest. In particular, due to the nature of the business formation, sole traders may be more difficult to identify and reach (e.g. do not appear on the Company House register of companies), and less likely to take the time to respond (e.g. having not chosen to incorporate may mean they do not want to answer questions on incorporation, or they may feel that as they have chosen a more 'informal' business formation they do not want to be bothered with a formal survey).

However, it is important that a large enough sample of both company directors and sole traders is collected to produce statistically robust analysis. The risk can be mitigated by clearly explaining the purpose and consequentiality of the survey, keeping it short and interesting, and offering incentives for completion. Different methods for reaching respondents will also be considered, including email invites, telephone invites, and other online and offline methods of distribution.

## 4. Next steps

The next stages of the project follow from the proposed methodology and are outlined in this section, including testing, implementation, analysis and reporting. Note that respondent privacy is considered at every stage of testing and survey implementation with data collection processes aligning to GDPR. No Personally Identifiable Information (PII) is kept by the project team, and data is handled according to the relevant regulations.

### 4.1 Testing

#### Cognitive interviews

The cognitive interviews will test the stated preference questionnaire and choice task format (including attribute specification) through a conventional iterative test-re-test process. This will be implemented via 3-4 waves of cognitive interviews with 20 respondents in total with incorporated company and sole trader business owners. The interviews will be conducted via video conference or telephone. They will be approximately 45-60 minutes in duration. Initially respondents will be briefed on the purpose of the exercise and what they are required to do. They will then self-complete a (draft) online version of the survey (mimicking the approach for the main survey), before answering debriefing questions. The debrief will follow a semi-structured questionnaire template that will probe respondent understanding of the survey, the ease/difficulty of the choice tasks, the clarity of the instructions provided for answering the survey and choice tasks, and motivations and reasons for their responses.

Within the iterative testing process the potential for strategic bias and hypothetical bias issues will be addressed. Insights from behavioural economics suggest that hypothetical bias is more likely to be observed in cases where respondents have a lack of experience of the outcomes, the choices involve risk and uncertainty and/or trade-offs between the present and future, and engender some form of emotional response (e.g. stress, anxiety, fear of losses, and regret). Therefore, the testing will include careful examination of how respondents perceive and respond to the choice task particularly in terms of the ongoing viability of their businesses.

Strategic bias may also be an issue. For example, if respondents expect that the survey results will influence fees charged for company incorporation there are risks of free-riding (understating WTP) or 'protest' responses (providing zero-WTP due to a rejection of the simulated choice setting). This challenge will be addressed through the cheap-talk and response consequence aspects of the survey questionnaire, as well as ensuring that motivations and reasons for responses are recorded in sufficient detail in follow-up questions that strategic behaviour can be identified and controlled for.

The SurveyEngine platform will be used giving flexibility to update the survey content and choice task design (i.e. the attributes that are tested, their definitions, and levels) between interview waves, allowing for responses to feedback and adjustment of the survey material. Based on the overall feedback from the interviews the survey material and specification of attributes (and levels) will be finalised for the pilot testing. Through this process the steering group will be kept informed through regular progress meetings covering the refinement of the attribute list, levels, and definitions.

## Pilot survey and analysis

The pilot survey is the culmination of the design and testing work. The purpose of the pilot is to provide an online field test of survey questionnaire and choice task as a practical test of the implementation process in terms of recruiting respondents from the panel and gauging the likely response rate for the main survey and fieldwork duration. A sample size of between 100-200 respondents will be selected depending on the business segmentation approach.

The pilot data will be analysed for the interim report. Given the sample size the results will be limited to the choice model estimations and average WTP or WTA estimates. Sample sizes will be too small to reliably identify differences between business segments. Data from the pilot is also used to update the experimental design, which improves the efficiency of the design in terms of the precision of WTP or WTA estimates from the main survey data (i.e. smaller confidence intervals for a given sample size).

*Note that a pilot respondent recruitment note is attached in Appendix 4.*

## 4.2 Implementation

The main survey will be administered online and implemented in accordance with the sampling strategy. The fieldwork duration will likely be 5-6 weeks given a target sample size of up to 2,000 respondents. Regular progress reports will be provided on completed interviews and the profile of the sample. The sample will be quality controlled with any 'speeders' or incomplete responses screened out. The fieldwork will be managed in conjunction with the SurveyEngine platform, which will provide support for recruitment from the respondent panel. Data will be password protected and securely transferred for analysis by the project team.

SurveyEngine is fully compliant with all current EU data protection regulations (i.e. EU-based servers). With the upcoming end of the transition period for the UK exit from the EU, the project data storage location can be moved to the UK data centre if necessary. No personally identifiable information will be held by either SurveyEngine or eftec, and only the anonymised survey response data will be accessible (Companies House will retain the PII).

## 4.3 Analysis

The analysis and models used to produce results for use in policy analysis will be developed in accordance with BEIS QA guidance. A full quality assurance log setting out the quality assurance processes and activities undertaken, and any issues raised will be kept. The quality assurance log will be provided to the client steering group after key phases of work is complete.

### Econometric analysis

A thorough analysis of the survey data will be conducted, providing a top line statistical summary of the data and breakdown by key company characteristics (e.g. legal status, size, turnover). The descriptive statistics will include the sample representativeness and respondent profile questions, along with the results for the experience, perceptions and attitude questions.

WTP/WTA values for (a) the business segments and (b) the overall pooled dataset will be conventionally estimated through the econometric analysis of the respondent choice data

(choice model estimation). The analysis will have the theoretical underpinning of the underlying theory of economic choice (the so-called 'random utility model'). This is a well-established economic behavioural framework that provides testable predictions about choice behaviour and allows the estimation of WTP and WTA from the survey data. In the analysis we will test a range of modelling approaches and specifications (e.g. conditional logit models, mixed logit models, latent class models). This is best practice for understanding respondent preferences (rather than relying on a single specification).

The results will be scrutinised to recommend the model that provides the 'best fit' to the data, and most reliable user preference information for estimating WTP/WTA for the business segments (e.g. in terms of the precision values and 95% confidence intervals). Statistical tests will be used to determine if WTP/WTA values differ across these segments and the results will inform the subsequent demand estimation and policy analysis. We will also test for status quo and non-linear effects (diminishing marginal WTP for improvements and gains-loss asymmetry). This is to ensure the robustness of results.

In addition to the estimation of attribute values, analysis will be conducted to provide more qualitative assurance of respondent understanding and the reliability of the survey data results. There is no single test of validity of the survey results and the analysis is based on the interpretation of range of factors. This includes:

- Respondent feedback to diagnostic and follow-up questions concerning the credibility of the survey and ease of completion.
- Evidence of strategic (e.g. free riding) or systematic (e.g. always opting for the same response) answers by respondents;
- Significant numbers of outlier responses to questions (e.g. high or low amounts); and,
- High non-response rates to questions.

The assessment of the validity of the survey results will be evidenced and summarised in the Draft and Final Reports.

Furthermore, although not part of the sample segmentation, a number of other respondent characteristics are collected through the survey which provide data that can be used to investigate differentiation in responses and WTP values for different types of business owner. These characteristics include:

- Business location;
- Age range;
- Gender;
- Educational attainment; and,
- Ethnicity.

### Demand estimation

The demand for business incorporation will be estimated based on the predicted shares from the econometric model results for each business segment and the overall pooled dataset. This will plot the predicted proportion of businesses that would opt for incorporation for a given combination of attribute levels (i.e. a particular company model in terms of liability, tax,

protections, fees). The combination of attribute levels to be represented in the scenarios will be confirmed with the project steering group.

### Policy analysis & aggregation

The attribute values (WTP/WTA) for business segments will be applied to estimate aggregate benefits over the national business population. Benefit values will be scaled up using the number of businesses estimated to be in each segment. This will draw on the data compiled in the evidence review. Illustrative policy analyses will also be provided by applying the demand estimation results and assessing the impact of alternative scenarios on aggregate benefit estimates (based on the number of companies opting for incorporation). The specific policy interventions to be examined will be discussed and confirmed with the steering group.

### Case studies

To provide a more rounded overall view of the research, a series of post-survey follow-up interviews will be included as case study 'vignettes' in the reporting outputs. These will be used to enhance the narrative of the reporting and draw out the various motivations that business owners have for deciding to incorporate companies (or not), the circumstances surrounding this choice, and how/whether alternative company models would alter their behaviour. Ten interviews split between incorporated companies and sole traders will be targeted at survey respondents who provide particular patterns of responses. In order to participate in the follow-up interviews respondents will be required to provide their consent to be contacted by the project team for this purpose.

## 4.4 Reporting

The reporting outputs will be formatted according to BEIS publication guidelines and will undergo robust QA checks.

### Summary report

The summary report will provide the headline findings from the research for a policy audience. The overall format and structure of the summary report will be confirmed with the steering group ahead of its submission. It will detail the objectives of the research and present the main results in non-technical terms, along with the case study vignettes. The policy uses of the results will be demonstrated according to the findings from the illustrative policy analysis and benefits aggregation. Following review and comment by the steering group the final version of the summary report will be prepared and submitted.

### Technical report

A technical report will describe the methodological approach to the work and the full set of results, including WTP/WTA estimates, results of model validity testing, aggregation, and estimated demand curves for different attributes and policy scenarios. Accompanying annexes will provide the stated preference questionnaire material and full statistical results for the survey. The technical report will also be accompanied by a fully completed QA log setting out the QA carried out (as per BEIS guidance). As with the summary report, the overall format and structure of the technical report will be confirmed with the steering group ahead of its submission. Following review and comment by the steering group the final version of the technical report will be prepared and submitted.

### Presentation

We will agree dissemination activities with the steering group but envisage presenting the study findings and conclusions to officials from BEIS, HMRC, Companies House and other departments/agencies as appropriate.

### Peer review

Independent peer review input will be provided to inform the development of the study and final deliverables. Feedback and comment from peer review will be reviewed in conjunction with the project steering group and appropriate updates and amendments made to the survey material, sampling approach, and econometric analysis, policy examples and interpretation as required.

# 5. Work plan

The workplan is presented in this section, containing the work programme (Gantt chart) in Figure 5.1 outlining the main work stages and the months over which they are scheduled to run, and the project milestones and deadlines in Table 5.1, as well as steering group meetings at key phases of the project, by date.

**Figure 5.1 Work programme**

	May-20				Jun-20					Jul-20				Aug-20					Sep-20				Oct-20			
w/c	4	11	18	25	1	8	15	22	29	6	13	20	27	3	10	17	24	31	7	14	21	28	5	12	19	26
Phase	1. Methodology development													2. Testing												
Project management	S1												S2												S3	
<b>1. Scoping</b>	M1																									
Task 1.1 Inception meeting																										
Task 1.2 Evidence & literature review																										
Task 1.3 Qualitative research																										
<b>2. Survey design</b>																										
Task 2.1. Survey design																										
Task 2.2. Sampling strategy																										
Task 2.3 Respondent panel																										
<b>3. Testing</b>																										
Task 3.1 Cognitive interviews																										
Task 3.2 Pilot survey																										
Task 3.3 Pilot analysis																										

	Nov-20				Dec-20				Jan-21				Feb-21				Mar-21				Apr-21					
w/c	2	9	16	23	30	7	14	21	28	4	11	18	25	1	8	15	22	1	8	15	22	29	5	12	19	26
Phase	3. Implementation and analysis																									
Project management																	S4								S5	
<b>4. Implementation</b>																										
Task 4.1 Main survey																										
<b>5. Analysis</b>																										
5.1 Econometric analysis																										
5.2 Demand estimation																										
5.3 Policy analysis & aggregation																										
5.4 Case studies																										
<b>6. Reporting</b>																										
6.1 Summary report																										
6.2 Technical report																										
6.3 Presentation																										

**Table 5.1 Milestones and deadlines**

Deliverables	Date (w/c)
Draft methodology report (segmentation D1)	August 10th
Draft survey instruments (survey design D2)	August 10th
Interim report (cognitive interviews and pil D3)	October 26th
Draft summary report	D4 February 22nd
Summary report	D5 March 15th
Draft final deliverables	D6 April 5th
Final deliverables (technical report, mode D7)	April 19th

  

Milestones	Date (w/c)
Inception meeting and project start	M1 May 4th
Draft segmentation and attribute long list	M2 August 10th
Draft survey (pre-testing version)	M3 August 10th
Respondent panel	M4 August 10th
Cognitive interviews complete	M5 October 12th
Pilot survey complete	M6 October 26th
Main survey complete	M7 December 5th
Econometrics analysis complete	M8 January 25th
Demand estimation results	M9 February 22nd
Policy analysis and aggregation results	M10 February 22nd
Case studies complete	M11 February 22nd
Presentation	M12 April 26th

  

Steering group meetings (video-conf)	Date (w/c)
Inception meeting	S1 May 4th
Phase 1 meeting - methodology developm	S2 July 6th
Phase 2 meeting - Testing	S3 October 26th
Phase 3 meeting - Implementation and ana	S4 February 22nd
Final presentation	S5 May 3rd



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# Appendix 1 – Qualitative interviews

## Research Approach

In total, 20 tele-depth interviews were undertaken with business owners – ten with limited liability companies and ten with sole traders. The target sample was primarily aimed at small businesses with one to four employees, across a range of sectors and different locations from across the UK. The exact composition of the sample is shown below in Tables A1.1, while brief descriptions of the interviewees are in Box A1.1 and A1.2.

In addition to these segments, there was a strong sector mix across the 20 interviews including retail, construction, health/beauty/hairdresser, hospitality and leisure, tradesman, recruitment, entertainment and the motor trade. The interviews were approximately 30 minutes in duration and followed a semi-structured follow a semi-structured discussion guide that explored the nature of the interviewee's business, the legal status, the reasons for their choice of legal status, the perceived benefits/disbenefits of alternatives, source of advice sought, and more wider aspects of business attitudes and experience.

**Table A1.1 Interviewee composition**

	Limited Liability	Sole Traders
<b>Turnover</b>		
• upto £99k	3	8
• £100-£249k	3	1
• £250-£499k	3	-
• £500k+	1	1
<b>Number of employees</b>		
• 1-4	6	8
• 5-49	4	2
<b>Location</b>		
• West Midlands	1	3
• Yorkshire	2	1
• London/South East	1	2
• South West	-	2
• North West	2	-
• North East	-	2
• Scotland	2	-
• East Midlands	1	-
• Northern Ireland	1	-
<b>Age of business</b>		
• 1 to 12 months	2	2
• 2 – 3 years	-	3
• 4 – 5 years	2	1
• 6 – 10 years	3	1
• 11 – 15 years	-	2
• 20+ years	3	1
<b>Employee splits</b>		
• Owner only	1	6
• Owner & P/T employees	3	3
• Owner & F/T employees	3	1
• Owner & subbies	1	-
• Joint owners	2	-

### Box A1.1 Sole traders

#### Sole Traders

A man had worked as a self-employed contractor on construction sites in France, Dubai Qatar and the UK for the past 20 years. Employed by various engineering firms, he had experience of managing 200 men on site, working on sizeable projects like building a hotel which involved 15,000 construction workers, and the metro in Qatar.

A lady had worked in hair dressing salon from 16-24 but experienced bullying from her last employer. To get away from the toxic culture, she decided to take on an office role in a large electricity distribution organisation (over 250 employees). However, she missed hairdressing and with the support her husband decided to buy her own salon and has been operating as a sole trader for the past 13 years.

Another woman had been a head chef from the age of 19, having worked in pubs and restaurants since 13. After 20 years of loving her job but experiencing anti-social hours uncondusive to family life, she decided to set as a sole trader in catering and hospitality 15 years ago.

A man worked over 6 years as a postman but when the Royal Mail was privatised, he felt there was much more politics and too much focus on the bottom line. He had underlying health issues and the stress he experienced made it worse, so he took redundancy. He spent a short stint as a self-employed plasterer with some success, but this too caused side effects for his breathing. Having researched potential opportunities, he decided to establish his ice cream business 2.5 years ago.

A lady who set up a recruitment LLC in 2007, decided to change tack and follow her creative passion. So, in November 2019, she established a headwear business, the target audience being festival goers.

A man had been in plumbing and heating since 1977 working for councils in the north east before moving to London where there was more work. In 1989, he got married and moved back to the north east setting up as a sole trader.

A woman had left school to do beauty therapy but ended doing odd jobs like singing in bars and in workwear for two years. She eventually got a job in a beauty salon and had worked there for five years before getting made redundant during Covid-19, and setting up as a sole trader in June 2019.

A man who had been in food retail for a number of years has been the owner of a supermarket since 2018. As well as working for his parents in the family food business, he had short spells in sales, as a cleaner and in manufacturing clothing.

And finally, a woman who had three jobs and never been unemployed. She started off in the navy at 19, before moving on to an engineering firm where she was office manager for seven years. In 2012, she established her knead therapy business as a sole trader as she wanted more flexibility to bring up her children.

### **Box A1.2 Limited Liability Companies**

#### **Limited Liability Companies**

People's career histories were incredibly varied. One had been self-employed as a cameraman doing the same job for over 20 years, but due to recent law changes in the last 12 months had been told to set up a limited company. Another had been self-employed in a dental lab since 1998, but because he had run up debts due to a failed business partnership, was advised to take on limited liability status to protect his assets.

One person had left school at 16 to do a mechanics apprenticeship and has worked in the car industry ever since, 15 years for different companies and 20 years running his own business.

Another person had left school at 16 with nine GCSEs and at 19 decided he wanted to do something for himself. He subsequently set up a sandwich shop, an asphalt business and a fencing business all with sole trader status. He did this for 13 years before he changed the status of the fencing business to limited liability in 2014.

Another left school and went to college to study engineering before getting into painting and decorating, and moving into construction work where he has had his own business since 2015.

One person had been a journalist with various national newspapers for 20 years, his most recent employment as a sub-editor. His passion was wine and had set up as a wine merchant in 2012.

A woman had grown up doing acting in her teenage years, and after completing a university degree set about doing musicals in London, as well as coaching people in acting and singing. After four years of networking and building up contacts, she set up a limited liability company.

Another had worked as a sole trader in the road haulage business from 1990 to 1995 before changing the legal status of the business to limited liability.

Two men had been working as self-employed construction workers for a number of years before deciding they wanted to set up a limited construction business last year.

And finally, one person had experience in the IT sector where he was a sales director. He made a career switch in to recruitment working as an employee with various large companies including Hays, but with an emphasis on IT. Feeling disenchanted with what he felt was a mercenary environment solely about making money, rather than offering a value added value service offering, he decided to establish a limited liability recruitment consultancy in the late nineties.

# Appendix 2 – Stated Preference Survey

See webpage

## Appendix 3 – Peer review comments

### Review and comments on Methodology Note and Cognitive Draft Questionnaire

Ken Willis

Newcastle University

24th August 2020

#### **Methodology Note: comments**

The Methodology Note by eftec provides wide-ranging review of the literature on the reasons business owners choose a particular form of ownership structure (sole trader, incorporation, partnership). The Note also provides a review of approaches available to appraise the decision on incorporation; with a comprehensive assessment of the research framework required to estimate the value of incorporation to business owners, in terms of their willingness to pay (WTP) for different aspects of business status.

I have a few comments on the work so far.

The Methodology Note provides an excellent outline of a well-established and good practice approach to the survey design for a discrete choice experiment (DCE) project.

eftec rightly conducted a literature review; and also undertook qualitative research, in terms of 20 tele-depth interviews of business owners to understand their situations and preferences in terms of the nature of their businesses; the legal status; reasons for their choice of legal status; perceived benefits/disbenefits of alternatives; advice sought; and business attitudes and experience. This was targeted at small businesses, across the UK, in different sectors (construction, entertainment, health-beauty-hairdresser, hospitality-leisure, motor trade, tradesmen, recruitment, retail).

The qualitative research, and literature review, led to a list of characteristics which influence incorporation. The challenge will be to define these characteristics in terms of factors or attributes which can be specified in a meaningful way on the discrete choice experiment (DCE) choice cards.

Some characteristics will be easy to define as factors on a choice card, being either binary or interval attributes; such as

- Company pension: Incorporated companies can treat pension contributions as an allowable business expense.
- Cost/Fee: Cost / Fee associated with registering as a limited liability company

Other factors, such as UK Corporation Tax, can also be specified unambiguously, and also expressed in interval terms e.g. 19% tax rate, 15% tax rate, 25% tax rate, etc.

However, some factors are more difficult to encapsulate as a well-defined attribute, such as:

- Access to finance: greater lines of credit. Respondents may interpret “greater lines of credit” in different ways: which additional lines of credit? and how much credit?
- Recruitment: Incorporated companies may have an advantage at attracting qualified applicants due to perceived credibility. This would need to be specified in probabilistic terms to account for “may”.
- Supplier criteria: Some larger companies are more comfortable hiring a registered company, rather than a sole proprietor to do the work (e.g. in the construction sector). What does this (“comfortable”) mean precisely: there is a greater probability (e.g. 20% extra chance) of being hired or offered a contract with incorporation compared to without?
- Reputation / business credibility: An incorporated company, as compared to a sole proprietorship, is generally afforded more credibility as a growing business. How can this factor be expressed in an unequivocal way on a choice card?

The list of factors identified as affecting the decision on incorporation seems comprehensive and logical, but great thought needs to be devoted to expressing some factors in a meaningful and unequivocal way.

Apart from this issue, the survey design is admirable. The “current situation” or status quo (SQ) position is included as a reference point on each choice card against which respondents can evaluate a change in factor levels.

The Note states that the DCE will presents 6 to 8 discrete choice cards (DCCs) to each respondent. This is a reasonable number of responses per individual, allowing the respondents to gain familiarity with the DCE process, without the respondent becoming bored and fatigued as would occur if they had too many DCCs to complete.

Sample size is difficult to calculate for DCEs. Sample size is determined by the true population proportion (p) and the relative error the investigator is willing to accept, as well as the number of choice scenarios. Often the true population proportion is unknown for many goods, but here the proportions of small companies which are in sole proprietorship or incorporated are documented in the Introduction to etfec’s note.

etfec suggest a total sample size of 1,259 to 1,750, with 250 to 350 in each of 5 sub-samples stratified by legal entity (sole trader or incorporated company) and number of employees (0, 1 to 4, and 5 to 9).

These sample sizes are reasonable. Assuming 5 levels as the maximum number of levels for any attribute, 3 alternatives on each DCC (SQ plus 2 hypothetical scenarios), and 6 DCCs per respondent, then a sample of 250 in each category should be more than sufficient to obtain statistically significant and reliable results for each stratification. The larger sample of 350 per each stratification may permit some additional analysis stratified by broad industrial sectors, or other categorization, if this is deemed relevant.

An additional issue is the number of attributes on each DCC. The Note lists 13 factors: 1 legal status; 4 financial factors; 3 commercial factors; 3 ownership factors; and 2 administrative factors. 13 factors are too many to include on one DCC, and so either some factors will need



to be omitted from the DCE, or more than one DCE included in the questionnaire survey. 13 factors on a DCC would lead to respondents adopting some simplifying heuristic, leading to attribute non-attendance (ANA) and possible bias in the DCE results.

However, including two DCEs in the questionnaire would lead to its own problem, namely how to link the two sets of attributes, so that they have a common preference weighting.

### **Questionnaire: comments**

The questionnaire structure and questions follow good practice guidelines, with initial screening questions to ensure a legitimate and representative sample, followed by factual and attitudinal questions to ensure respondents focus on the task (incorporation or not), before the discrete choice experiment (DCE) questions are presented to respondents. The questionnaire rightly includes some follow-up questions to assess the validity of the DCE responses. The questionnaire appropriately ends with questions about the respondent's characteristics.

The draft cognitive questionnaire is generally well constructed. Cognitive testing will improve the questionnaire and should allow any ambiguities in meaning and wording to be removed, with improvement to the clarity and wording of the questionnaire and information provided to respondents.

My thoughts on the draft questionnaire are:

- Q7: How long ago did you first set up your business?
- Q8: [If incorporated] How long has your company been incorporated?

People are sometime vague in their responses to "how long ago" questions, or perhaps round to the nearest 5 or 10 years. I suggest a supplementary question in both Q7 and Q8: "In which year was that?".

Q15: What percent of your business revenue would you estimate is dependent on your business status (i.e. unincorporated or incorporated)?

I think this is fine in a cognitive interview, but its purpose needs to be clarified if it is to produce discriminating answers across respondents. My initial response to this question would be 100% of revenue is dependent on the current status of the business.

### **Conclusions**

The research outlined by eftec has been meticulously and expertly planned. The methodology is excellent; with the questionnaire to implement the DCEs still needing to be finally formalised, to ensure accurate and robust estimates of owners' preferences and WTP for factors determining incorporation. The cognitive interviews using the draft questionnaire should ascertain whether respondents can clearly understand the tasks required and provide meaningful responses to questions asked.

The Department of Business, Energy and Industrial Strategy can have confidence in the methodology proposed, and qualitative research undertaken, by eftec, going forward to the pilot survey of business owners' preferences on incorporation.

# Appendix 4 – Sample composition and pilot recruitment notes

See webpage

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