

Forming a business



Once you have made up your mind to go ahead, you need to get to grips with the legal requirements for forming a business.

Setting up your business in the right way keeps costs down. It can also help prevent your working relationships turning sour, one of the major causes of business failure. This briefing covers:

- Deciding whether to operate as a sole trader, a partnership, a limited liability partnership or a limited company.
- Choosing a business name, and other legal requirements.
- Agreements between business partners.

1 Legal form

1.1 There are four main choices for the **legal** form of your business.

- If you are a sole trader, you are self-employed, with no special legal structure.
- In a partnership, two or more self-employed people work together as partners and share the profits (or losses).
- A limited company is a separate legal entity, distinct from its shareholders, directors and employees. Unlike a sole trader or partnership, it is not the same as the individuals who own or run it. For example, it is a separate legal entity and can sue or be sued in its own name.
- A limited liability partnership has some of the advantages (and disadvantages) of both a company and a partnership. For example, it is a separate legal entity and can continue despite the resignation or death of some members.

Other legal forms can be used. For example a co-operative belongs to the employees.

Community Interest Companies give social enterprises the flexibility of the limited company form, but with additional features to ensure that they operate for the good of the community, not simply for private gain.

1.2 It is possible to **change** the legal form of your business after you have started trading, but any change will take time and money.

- If you have registered for VAT, you will have to tell your local VAT office within 30 days of the change.
- Your accountant can give advice on other tax-related issues.

The advantages and disadvantages of each legal form are explained in **2, 3, 4** and **5**.

2 Sole trader

Most small start-up businesses find that setting up as a sole trader is the best option.

2.1 There are several **advantages**.

- You can keep simple, unaudited accounts.
- National Insurance is low.
- Unless your earnings are high, total tax payments can be lower than if you formed a limited company.
- Setting up is quick and easy. You will need to tell the tax and VAT authorities (see **8.3**).
- You can form a limited company later and transfer the business to it, though some stamp duty may have to be paid.

2.2 The disadvantages are relatively few, but could have **serious implications**.

- You are personally liable for all your business debts. This means that your own assets — all of them — are at risk.
- You are entitled to fewer social security benefits.
- Your options for raising money are limited.
- If you are a sole trader, it is harder to sell the business or pass it on.

3 Partnership

3.1 A partnership has **similar** advantages and disadvantages to a sole trader. But there are two other factors to take into account.

- Each partner is personally liable for all the business debts of the partnership (other than tax on profits), even if another partner caused them.
- You may be able to raise money by introducing new partners.

Get it in writing

A shareholders' agreement helps all the people involved in starting a new company know where they stand, just like a partnership agreement (see **6.1**). It should cover key issues for the business and likely 'what-if' scenarios, including:

- Investing money. Who contributes how much and in what form (eg as shares or as a loan), for what reward?
- What happens if more capital is needed next year? How much will the company need to borrow and on what terms?
- Withdrawing money: what dividends, directors' fees and salaries will be paid?
- What happens if one person needs to take out extra money?
- Responsibilities. Who makes decisions? Who is responsible for each business area? How will progress be monitored?
- Growth. How fast will you expand? Into which areas of business? How much risk are you ready to accept?
- Split up: can you buy each other out? Can you split the company up? How? And how will the shares be valued?

Discussing and settling these issues is vital from the start. It minimises the risk of people feeling they are putting in too much time and effort for too small a share of the rewards.

3.2 You can set up most partnerships with a few **formalities**.

- To avoid disputes, it is vital to have a comprehensive agreement drawn up by a lawyer and agreed by all partners (see **6.1**).

4 Limited company

4.1 The **advantages** of having a company tend to increase as your business grows.

- A limited company has more credibility.
- Normally, your liability is limited to the amount you agree to invest in the company by buying its shares. However, there are still circumstances where personal liability may arise. For example, by giving personal guarantees or security on company borrowings or the company trading wrongfully or fraudulently.
- It is easier to raise large sums of money for the business or sell a part of the business.
- There can be tax advantages for high earners through keeping money in the business or making pension payments.

4.2 The **disadvantages** are associated with greater costs and obligations.

- Annual accounts are generally more complicated.
- If your turnover climbs above £6.5 million an independent audit is compulsory and you will be required to appoint an auditor. This will usually cost you at least £2,000. It is a criminal offence to recklessly or knowingly include misleading, false or deceptive matters in an audit report.
- National Insurance payments are higher. You have to pay employer's and employees' National Insurance contributions on salaries including those of company directors.
- Other rules can make running a limited company more difficult. Contact Companies House for its Guidance Booklets (0303 1234 500 or www.companieshouse.gov.uk).
- If you decide to cease trading, it can be more difficult and expensive to wind up the company.

4.3 Forming a limited company involves some **red tape**.

- A limited company must be registered at Companies House.
- One option is to ask your solicitor or accountant to buy you an off-the-shelf company. Additional fees may be payable if you want to change the company

“If two individuals work on a business project together, they may be deemed to have formed a partnership (in the eyes of the law), even if they never decided to form one. So you can unwittingly end up liable for your colleague's debts on the project. Always seek professional advice.”

**Graham Bayliss,
Coventry &
Warwickshire
Chamber of
Commerce and
Business Link**

name and the amount of share capital. Alternatively, use a reputable company registration agent. Many reputable agents can incorporate a company electronically on the same day for no additional fee.

- You can undertake the registration process yourself but should seek professional advice before doing so.

4.4 You must **appoint** at least one director who must be an actual person as opposed to another company.

- It is no longer necessary to appoint a company secretary although you may choose to do so. The company director can hold both positions.

5 Limited liability partnerships

5.1 It is possible to set up a **limited liability** partnership.

- It is a corporate body with its own legal identity and capacity.
- Members can limit their liability for losses, although personal liability can arise in circumstances similar to those applicable to limited companies.
- It has the organisational flexibility of a partnership.
- It is taxed as a partnership — tax is charged on all the profits, whether or not they are distributed to members.
- Annual accounts must be prepared and filed. There are other filing requirements with strict time limits for compliance.
- Withdrawals may be clawed back if the

What's in a name

Choose a name that will create a positive impression and help your marketing. For example, suppose Peter Smith and Lisa Jones set up a delivery business based in Bristol. They might consider several names:

- Action Deliveries sounds like a dynamic delivery business. It would come near the top of any alphabetical list, such as in Yellow Pages, and is easy to remember.
- Bristol Deliveries would tell people what the business does and where it does it.
- Smith Jones provides no information on its product or service, so could leave potential customers none the wiser.
- S&J Deliveries sounds like a small, and perhaps amateurish, delivery business.

limited liability partnership is declared insolvent within the next two years.

5.2 A limited liability partnership must be **registered** at Companies House.

- It is important to have a suitable and confidential members' agreement drawn up (see box, page 2).

You may want to use an accountant, solicitor or registration agent to deal with the registration formalities.

6 Working relationships

If a business is going to have more than one owner, the owners must determine what their working relationship will be. It is vital to discuss the main issues and write down an agreement.

6.1 In the case of a business trading as a partnership (see **3**), it is normal practice to draw up a formal **partnership agreement**, which everyone signs. This should include:

- The names of the partners and the name of the business, and what it does.
- The date the partnership starts and how long it will last (if not permanently).
- The capital each partner is to contribute.
- How the profits (and losses) are to be shared and how much money each partner can draw from the business.
- How the business is to be run. For example, how much time each partner puts into the business and a limit on the value of cheques which require only one signature.
- Details of holiday entitlements.
- What to do if partners die, become ill, want to retire or reduce their involvement.
- What the arrangements will be for introducing new partners.

6.2 The **founding shareholders** in a limited company (see **4**) often overlook the problems that can arise.

Although the company's memorandum and articles cover some areas, the shareholders should have a separate written agreement.

6.3 The members of a limited liability partnership should have a **members' agreement**. Take advice on the best form for the agreement.

7 Your business name

7.1 You can trade under your own **name**, or choose a different business name.

- A sole trader can use his or her own name or a business name.
- A partnership can trade under the names of all the partners or a business name.
- A limited company or limited liability partnership can trade under its registered name or use a different business name. If you buy an off-the-shelf company you can apply to change the registered name.
- To further protect your business name from use by others you can register it as a trade mark, or a domain name (for your website and email addresses), or both. The Intellectual Property Office regulates trade mark registration (08459 500505 or www.ipo.gov.uk). To check web domain names free of charge, search at a name registration service such as www.netnames.co.uk.

Always check you are not infringing any trade marks with the name you pick (see **7.2**).

If you trade under any name other than your own or your registered business name you must disclose the ownership of the business and an official address on your stationery, on a sign at your premises, on your website (if you have one) and to any business contact who asks for it.

7.2 Certain names are **not allowed**. The name must not be misleading or likely to cause confusion with an existing business. Names judged to be offensive are also banned by Companies House.

- Choose a name that will create a positive impression and help your marketing.
- Check the name you want to use, or one close to it, is not being used by another business in a similar line. Check the Companies House index of company and limited liability partnership names at www.companieshouse.gov.uk or use a company registration agent. The fact a name is not in use does not necessarily mean you will be able to use it.
- An agent can check for names which are already registered as trade marks.
- You must not use ligatures, accents or diacritics in the spelling of the name, as these make it difficult for people to search for your company's public records.

7.3 Certain words are **prohibited** by law. For example, British, Royal and Bank.

- Only limited companies can use the word Limited or Ltd in their names. Other words may need to be justified. For example, international.
- Only LLPs can use limited liability partnership or LLP.

Download a PDF of booklet GP1 from the Companies House website on prohibited words (www.companieshouse.gov.uk/about/gbhtml/gp1.shtml), or check with your solicitor or company registration agent.

8 Other legal requirements

8.1 You may need some form of **licence** (eg for running a nursing home or a betting shop).

- Some licences, such as the licence to sell alcohol in a pub, are personal. You cannot assume you will get a licence because a previous owner had one.

8.2 Do you have adequate **insurance**?

- If you have employees, you must have employers' liability insurance.

8.3 Get your tax, National Insurance and VAT affairs **organised**.

- Notify your Inspector of Taxes and the Department for Work and Pensions when you start trading.
- If you are going to employ people, ask HM Revenue & Customs to send you a new employer's starter pack (08456 070143).
- If your sales will quickly reach the VAT threshold (£73,000), ask your accountant when you should register for VAT.

8.4 You must ensure your premises **comply** with property regulations. For home-based businesses, the main issues are:

- Do your title deeds, mortgage or tenancy agreement prohibit business activities?
- Do you need planning permission?
- Will your home cease to be 'essentially residential'? Will the business generate traffic or visitors or disturb neighbours? If part of your home is treated as non-residential, there may be tax implications.

8.5 All businesses have to comply with **health and safety regulations**, even if they are home-based.

8.6 Ensure your business does not fall foul of **environmental** regulations.

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