

Forming a business



Whether you are forming your first business or adding to an existing one, it pays to set it up correctly. Choosing the wrong business structure will expose you to unnecessary costs and risks. Failing to address the key practical issues can result in you falling out with business partners or stakeholders. This briefing focuses on:

- The relative advantages of trading as a limited company, a limited liability partnership, a partnership or a sole trader.
- The mechanics of setting up a business, to comply with the law.
- Choosing a name for your business.
- The most important practical issues — agreeing the strategy and key operational and personnel issues.

1 Choosing the legal form

The legal form you choose for your business will depend on your commercial needs, the financial risk you are willing to take, and your tax position.

1.1 Setting up a **limited company** offers flexibility if you plan to grow the business. (See **2**).

- A limited company is a separate legal entity, distinct from its shareholders, directors and employees. The business can continue despite the resignation, bankruptcy or death of directors or shareholders. The company can only cease as a separate entity through striking off or winding up.
- It is relatively easy to involve outside investors by selling them shares although it is always worth being careful about who

you allow to become shareholders as they share in the ownership and possible the decisions making of the company.

- The risk of loss is normally limited to your investment, primarily in share capital, although if you stand as personal guarantor for any of the company's debts, the risk of loss is potentially greater. There may be a risk if you do not comply with legal statutory requirements.
- Limited companies are often perceived as having a better reputation than sole traders.

Some of these benefits are also available in a limited liability partnership (see **1.3** and **4.6**).

1.2 You may choose to operate as a **sole trader** if you are the owner-manager of a small business. Setting up is easy. (See **4**).

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- You are self-employed. You personally own the assets of the business and are personally responsible for any profits or losses of the business.
- 1.3** You can form a **partnership** if two or more of you work as partners, sharing the profits or losses. (See 4).
- You and your partners personally own the assets of the business. Any losses would normally be shared between you. But if others cannot pay their share, you are liable for their share, as well as your own.
 - Alternatively, you can set up a limited liability partnership (LLP), in which individual members have protection from the partnership's debts, but they have to make more information available.

Although some businesses establish themselves as limited companies from the outset, many start life as sole traders or partnerships, then incorporate as LLPs or limited companies once they are ready to grow. It is not expensive to set up a limited company, but you will have to observe the rules.

2 Limited company

Trading as a limited company can be a good way of limiting the risks of personal financial loss.

- 2.1** Your **liability** is normally limited to the amount you agree to invest in the company by buying its shares.
- If the business goes into liquidation owing money, the creditors are paid out of the sale of the assets of the company. The creditors might include suppliers, employees, your bank, or HM Revenue & Customs (HMRC).
 - Under normal circumstances, creditors have no legal right to obtain repayment from the directors or other shareholders of the business unless the law has not been complied with in some way. The debts of the company should not affect the directors' personal credit ratings.
- 2.2** You can raise money for the business by selling **shares** in the company to interested parties, including other businesses.
- You may wish to tie in key managers by offering them a stake in the business.
- 2.3** Having a limited company may make it easier to raise other types of **finance**.

- A bank can take fixed and floating charges over the assets of the company (often known as debenture).

2.4 Limited companies pay **corporation tax** on their profits.

- Directors and other employees pay income tax on salaries and benefits through PAYE.

2.5 You must submit **annual accounts** and tax returns to HMRC, and file a set of accounts with Companies House to make information on the company's finances publicly available. There are fines if you miss deadlines or submit incorrect information.

- Most small companies with a turnover of less than £6.5 million and assets of less than £3.26 million do not need to have their accounts audited and so are not required to appoint an auditor. They still need to meet legal and accounting regulations and will need to consult an accountant.

2.6 There are a number of **other statutory requirements** that you must fulfil on an annual or ongoing basis.

- For example, your annual return to Companies House must contain various details of the company and its directors.

3 Becoming limited

3.1 You can set up a new limited company with minimal effort using a **company registration agent**, or your accountant or solicitor.

- Check whether the agent you use is known and reputable.
- Most agents can also provide a full 'company kit' to save you time. It includes a company seal (if required), a combined register containing the required statutory registers, and all the necessary forms. Additional services might include providing a registered office and company secretary.
- Most companies are created with Memorandum and Articles of Association, based on a standardised form, setting out what the company and its directors and shareholders may and may not do. The aim is to achieve a good balance of flexibility and protection for all concerned.
- Alternatively, any special needs can be met by drafting them into the Memorandum or Articles. For example, you might put in provisions about transferring shares and ownership, or you may prefer to keep these separate in a shareholders' agreement.

Community Interest Companies (CICs) 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.

3.2 To **speed up** the process, you can buy an 'off-the-shelf' (ready-made) company.

- An additional fee may be payable for changing details such as the company name and the amount of share capital.
- Many reputable agents can incorporate a company electronically on the same day for no additional fee.

3.3 You can complete the whole **company formation** process yourself, using the guidance notes and forms provided by Companies House (0870 333 3636, www.companieshouse.gov.uk). However, many people start out using this approach, only to give up once they realise how complex the process is.

3.4 When you are setting up the company, you must **appoint** at least one director who must be a 'natural person'. Another company is not permitted to be the sole director. It is no longer obligatory to have a separate company secretary. The company director will be able to hold both positions.

4 Sole trader or partnership

Most small businesses operate as sole traders. If two or more people go into business together, they may choose to trade as a partnership. Partnerships can be a good way of sharing management burdens and making sure people commit to the success of the business. But be aware of personal liability issues.

4.1 You are **personally liable** for all your business debts.

- There is no limit to the extent of your liability. If you cannot pay off your business debts, you can be made bankrupt.
- In a partnership, each partner is liable 'jointly and severally' for all the business debts of the partnership. This means that, if the business fails, you could end up having to pay your partners' share of the debts, as well as your own. But for income tax purposes each partner is only liable for their own share of the profits.

4.2 You personally **own the business assets**.

- In a partnership, the assets are jointly owned, along the lines set out in the Partnership Agreement (See 4.5).

4.3 You pay **Schedule D income tax** on any taxable profits.

- Your profits will be taxed at the appropriate personal rates.
- You pay tax on the profit, even if you have no actual drawings from the business.
- Ask your financial adviser whether your overall tax liability is likely to be lower if you are a sole trader (or partnership) or a limited company.

4.4 Your **National Insurance contributions** are generally lower than if you are an employee of a limited company.

But there are restrictions on your entitlement to social security benefits.

4.5 In a partnership, it is normal to agree all your commitments at the outset in a **Partnership Agreement**.

- This critically important document covers matters like the money you put in and take out, holidays, adding (or removing) partners and how the business will be run. It is negotiated between the partners, often with the help of their professional advisers. Among other things, it should cover all the points in 7.
- A 'sleeping partner' is one whose involvement extends only to contributing capital and sharing in the profits.

4.6 You can limit your liability in a partnership by setting up a **limited liability partnership**.

- This is a corporate body with its own legal identity and capacity.
- It has the organisational flexibility of a partnership.
- It offers limited liability to members.
- It must be registered at Companies House.
- Annual accounts must be prepared and filed. There are other filing requirements, similar to those for the limited company which have time limits for compliance.
- The partnership agreement is confidential to members.
- Withdrawals may be clawed back, if the partnership is declared insolvent within the next two years.
- If you are a member of a trade association, check to see whether it has any conditions which may apply to your LLP registration.
- Being a member of an LLP can minimise NI contributions.

5 Choosing a name

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

“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

- A limited company can trade under its registered name or use an alternative name, provided that the ownership and limited liability of the business is disclosed.
- Partnerships can trade under the names of all the partners or a business name.
- Sole traders who trade under anything other than their own name must declare themselves 'sole trader' or 'owner' or 'John Smith trading as John Smith Antiques' on their stationery.

5.2 Businesses are **not allowed** certain names.

- Check that the name, or one close to it, is not being used by another firm in a similar line of business.
- Check the Companies House Index of Registered Limited Companies and LLPs at www.companieshouse.gov.uk/info, or get a company registration agent to do it. (This will not include names of sole traders or partnerships, or 'trading as' names).
- In addition, agents can check the Trade Marks Registry for names which have been registered as trade marks. You can also carry out a basic check on the UK Intellectual Property Office website (www.ipo.gov.uk).
- The name must not be misleading or offensive. Words such as 'International' may need to be justified.
- Certain words are prohibited. For example, 'British', 'Royal' and 'Group' unless their use can be qualified.

Ask Companies House for the booklet (code GBF2) on prohibited words, or check with your company registration agent.

6 Other legal requirements

6.1 Find out if you need a **licence**. For example, running a nursing home requires a licence.

6.2 Check you have adequate **insurance**.

- Some insurance, such as employers' liability, is compulsory even if you, the director, are the only employee.

6.3 Get advice from your accountant with regard to **tax and VAT**.

- You must register for VAT if your sales ('taxable supplies') in a 12-month period are, or are expected to be, more than £67,000.
- Notify your Inspector of Taxes and the Department for Work and Pensions when you start trading.

6.4 Register with your PAYE tax office when you are likely to **employ people** — directors of limited companies are classed as employees too. Contact the New Employer Helpline (08456 070143).

7 A common pursuit

Many of the difficulties and disagreements arise over everyday policies and practices, rather than legal structure. You can avoid most of these problems by drawing up a comprehensive agreement on how the business should be run. Ideally, you need to discuss these issues with your partners and key employees.

7.1 Discuss what **motivates** you all.

- Why do you want to start a new business?
- What is the purpose of your business?
- Be frank about personal priorities — work, family, money, holidays, cars, travel.

7.2 Agree your **business strategy** and the short and long-term objectives you are working towards.

7.3 How will you manage the **finances**?

- How is the business going to be financed?
- How much will different partners contribute?
- How will profits (and losses) be shared?

7.4 Discuss **responsibilities**.

- Who will manage what?
- What is the decision-making process?
- How will you resolve disagreements?

7.5 Discuss day-to-day **operations**.

- How will you reward different individuals?
- What holidays are different people going to be entitled to?
- Will any friends or relatives be on the payroll?

7.6 Discuss '**what if**' scenarios and write down your conclusions.

- What if you need to raise more money?
- How will you cope if one of the partners decides to leave the business?
- Do you have an exit plan? For example, do you aim to sell the business at a certain stage?

Expert contributors

Thanks to **Geoff Wightwick** (Baker Tilly, 0161 834 5777); **Graham Bayliss** (Coventry & Warwickshire Chamber of Commerce, 02476 654321); **Frank Thaxton** (Thames Valley Partners Ltd, 0207 6371727).

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