

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.

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 die 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 let become shareholders as they share in the ownership 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. 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).

- You are self-employed. You personally own the assets of the business and are personally liable for any business losses.

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 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 your 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, HM Revenue & Customs.
- Under normal circumstances, creditors have no legal right to obtain repayment from the directors or other shareholders of the business. 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.

2.4 Limited companies pay corporation tax on their profits. (See Corporation tax).

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

2.5 You must submit annual accounts and tax returns to HM Revenue & Customs, 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 the deadlines or fail to submit the correct information.

- Most small businesses and limited liability partnerships (LLPs) are entitled to submit abbreviated accounts to Companies House.
- Most small companies with a turnover of less than £5.6m do not need to have their accounts fully audited. Those turning over between £5.6m and £22.8m do not need a full audit but still require a report from a qualified accountant. (See Preparing for your annual accounts).

2.6 There are a number of other statutory requirements that you must fulfil on an annual or ongoing basis. (See Role of the company secretary).

- 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 by 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 documentation such as the Minutes of the First Meeting. 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.

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, and a company secretary (who can be a second director, but does not have to be).**

- The same person cannot act as both sole director and company secretary.

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 (see 4.1 and 4.6).

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 his or her own share of the profits.

4.2 You personally own the assets of the business.

- 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 section 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 registration as an LLP.
- 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.

- A limited company or LLP 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.

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).

- Agents can also check the Trade Marks Registry for names which have been registered as trade marks.
- 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. Check the Internet before registering in case someone already uses it on the web. Registration agents will normally include this check free of charge.

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. (See Insurance to protect your business).

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 £60,000 (2005/06 rates).
- 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 in managing a business 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, not only with your partners but also with 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 are different partners going to 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 are you going to 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?

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