Think Ahead ACCA

Guide from

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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 exposes you to unnecessary costs and risks.

Your main options are being a sole trader, partnership, limited company or limited liability partnership. If you are going into business with other people, you also need to address practical issues and your working relationship.

1. Choosing the legal form

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

Setting up a limited company offers flexibility if you plan to grow the business

- 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.
- It is relatively easy to involve outside investors by selling them shares. It is always worth being careful about who you allow to 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.
- Some of these benefits are also available in a limited liability partnership.

Setting up as a sole trader is the easiest way to start a business

- Setting up as a sole trader is easy.

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

Two or more of you can work as partners in a partnership

- In a partnership, each partner is normally self-employed. The partners personally own the assets of the business and share the profits or losses.
- If your partners cannot pay their share of any losses, you can be 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.

Other options may suit social enterprises and community organisations

- For example, registering a company as a community interest company.

2. Limited company

Setting up a limited company can reduce the risk of personal financial loss

- Personal risk is generally limited to how much you invest in the business and any personal guarantees given to obtain finance (such as bank loans).
- If the business goes into liquidation owing money, creditors are paid with any money from the sale of the company's assets.
- Under normal circumstances, creditors have no legal right to obtain repayment from the directors or shareholders of the business (unless they have given personal guarantees).
- Directors can be held personally liable in some circumstances: for example, if they have allowed the company to trade fraudulently or while insolvent, or have been negligent.

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

- A limited company has more credibility.
- It is easier to raise large sums of money or sell a part of the business.
- You can tie in key managers by offering them a stake in the business.

- There can be tax advantages for high earners through keeping money in the business or making pension payments.

Administrative costs and obligations can be significant

- You must submit annual accounts and tax returns to HMRC. Annual accounts are generally more complicated than for the self-employed.
- If your turnover is above £10.2m for financial years begin on or after 1 January 2016 (previously £6.5m), an independent audit is compulsory and will usually cost at least £3,000.
- You must also file an annual return and annual accounts with Companies House, making some information on the company’s finances publicly available.
- There are a number of other statutory requirements. For example, you must let Companies House know about any change of directors. You risk a fine if you miss deadlines or submit incorrect information.
- You need to set up a payroll and register as an employer with HMRC.
- If you decide to cease trading, it can be more difficult and expensive to wind up the company.

The company pays corporation tax on its profits and you are taxed as an employee

- Company directors pay income tax on salaries and benefits through PAYE like other employees.
- National insurance contributions (NICs) can be higher than for a sole trader or partnership. You have to pay employers’ as well as employees’ NICs on salaries, including those of directors.
- As a shareholder in a limited company, you may be able to take dividends without any NICs being payable.

3. Becoming limited

You can set up a new limited company with minimal effort

- You use 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. This 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.

As part of the process, you create ‘articles of association’

- These are the rules governing how the company is run. For example, the articles set out any restrictions on what the company can do and how decisions will be made.
- You can use standard model articles of association, or change them to reflect your particular requirements. For example, you might want to include restrictions on transferring shares to other people.

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.

You can complete the whole company formation process yourself

- Guidance notes and forms are available from Companies House.
- If you are happy to use the model articles of association, you can incorporate a private company online using the Companies House Web Incorporation Service for a fee of £15.
- If you want customised articles, you may prefer to use an agent.

When you set up the company, you must appoint at least one director

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

4. Sole trader

The owner-manager of a small business can operate as a sole trader

- You must register with HMRC within three months of starting up.
- The administrative burden is far lower than for a limited company. You keep simple, unaudited accounts recording your business income and outgoings.
- Despite the name, a sole trader can employ people.
- You can decide to form a limited company later and transfer the business to it, although some stamp duty may have to be paid.

The biggest disadvantage is your personal risk

- You are personally liable for all your business debts. This means that your own assets – including your home – are at risk. If you cannot pay off your business debts, you can be made bankrupt.
- Your options for raising money are limited.
- It is harder to sell the business or pass it on.

Sole traders are generally taxed as self-employed

- Income tax is payable on any profits, not on the amount taken from the business.
- NICs are usually lower as a sole trader than as an employee of a company. However, you are entitled to fewer social security benefits.
- Ask your financial adviser whether your overall tax and NI liability is likely to be lower if you are a sole trader (or partnership) or a limited company.

5. Partnership

A partnership allows you to share profits, management responsibilities and risks

- As a member of a partnership you are personally and jointly liable for any debts incurred. If another partner is unable to pay, you become liable for their share of the business debts.
- Your possessions can be at risk if you fail to pay your debts.

- You may be able to raise money by introducing new partners. A ‘sleeping partner’ is one whose involvement extends only to contributing capital and sharing in the profits.
- Business contracts entered into by one partner can be binding even if the other partners have not consented.

You can set up most partnerships with a few formalities

- The partnership must be registered with HMRC. Each partner must also register as self-employed.
- To avoid disputes, it is vital to discuss working relationships and have a comprehensive agreement drawn up by a lawyer and agreed by all partners.

Members of a partnership are generally taxed as self-employed

- Income tax is payable on each partner’s share of any profits.

6. Limited liability partnership

You can set up a limited liability partnership (LLP)

- Despite the name, this is not a partnership. It is a corporate body with its own legal identity and capacity.
- An LLP has the organisational flexibility of a partnership. Members share management responsibilities and you may be able to introduce new members to raise money.
- Each member’s liability is limited to any personal guarantees they have made to secure finance and any money they have personally invested.
- Any withdrawals of capital from the business can be clawed back if the partnership is declared insolvent within two years of the withdrawal.

Forming an LLP is more complicated than setting up a partnership

- You must register with Companies House or use an agent to do this for you.
- Self-employed members of an LLP must register as self-employed with HMRC within three months of starting up.

- It is important to have a suitable and confidential members' agreement drawn up.

You must comply with a range of administrative requirements

- These are similar to those faced by limited companies.

Members of an LLP are generally taxed as self-employed

- Income tax is payable on each partner's share of any profits.

7. Your business name

You can trade under your own name or choose a different business name

- 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.
- 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 and to any business contact who asks.

The name of a company or LLP must be registered with Companies House

- All company names must end with the words 'Limited', 'Unlimited', 'Public limited company' or their abbreviations.
- Limited liability partnerships must have 'Limited liability partnership' or 'LLP' in their names.

You should check whether other businesses are already using similar 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. This does not include names of sole traders or partnerships, or 'trading as' names.
- Check the Trade Marks Registry for names which have been registered as trade marks.

- Check the internet. Even if you do not intend to set up a website now you may want to register a domain name in case you do in future.

Businesses are not allowed certain names

- The name must not be misleading – for example, about the legal status of the business – 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.
- You must not use ligatures, accents or diacritics in the spelling of the name, as these make it difficult for people to search for public records of your business.

8. Other legal requirements

You may need a licence

- For example, running a nursing home requires a licence.
- Ask your local authority, business support agency or solicitor for guidance.

Check you have adequate insurance

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

Get advice from your accountant with regard to tax and VAT

- Notify your inspector of taxes and the Department for Work and Pensions when you start trading.
- You must register for VAT if your sales (‘taxable supplies’) in a 12-month period are more than £83,000 (2016/17) or sales are expected to exceed this limit in the next 30 days alone.
- Register for PAYE if you are going to employ people. If you are paid a salary by your own company, you count as an employee subject to PAYE.

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.

All businesses must comply with health, safety and environmental regulations

- This includes home-based businesses.

9. Working relationships

Agreeing how the business should be run can help avoid problems

If the business is going to have more than one owner, you should discuss key issues including:

- what your personal priorities are and what the business strategy should be
- how you will manage the finances, including how much each individual will contribute and take
- who will manage what and how you will take decisions
- how you will resolve disagreements
- day-to-day issues like holidays and whether you will employ friends and family
- what will happen if one of you wants to leave the business.

For partnerships, it is normal practice to draw up a formal partnership agreement

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
- 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.

The founding shareholders in a limited company often overlook potential problems

- Although the company's articles of association cover some areas, the shareholders should have a separate written shareholders' agreement.

The members of an LLP should have a members' agreement

- Take legal advice on the best form for the agreement.