
Setting up your business – part I

The basic structure

By Alan Zeffertt

When setting up your business, the first decision to be made is what to trade through – a company, partnership, limited company or limited liability partnership?

In addition to assessing the company's likely future commercial risks, owners need to consider their longer-term objectives, in terms of the business itself but also personally. Taxation will be an important factor in structuring a business.

Deciding how to trade

Your decision to trade through a company, partnership or LLP will be governed by a number of factors, including liability and taxation.

Liabilities

The situation for sole traders is simple: they are personally liable for all debts and obligations incurred by their business.

In the case of a partnership, each partner is jointly liable with the other partners for all debts and obligations of the partnership which are incurred while a partner. Each partner is also jointly and individually liable for loss and damage to third parties caused by the 'wrongful acts or omissions' of any of the partners in the ordinary course of the partnership business or with the authority of the partners. For example, a partner's liability to third parties is not affected by any agreement made internally with his or her partners.

Significantly, a partner's liability continues after retirement for subsequently incurred debts of the partnership to creditors who, knowing him to be a partner, have not received notice of his retirement.

What this means is that both sole traders and partners risk losing all their personal assets to meet debts if their business fails. They need to minimise risk where possible, for example by securing fidelity insurance to cover employee fraud, or, in the case of partners, by taking indemnities from co-partners to cover 'wrongful acts.'

Limited companies

The alternative to personal liability is to run the business as a limited company. Any individual who joins the company can avoid incurring personal liability to company creditors. A company member's liability is to the company itself and is limited to the amount the individual agreed to contribute when joining the firm.

This is the main advantage of a limited company over other forms of business structure. It is particularly attractive to someone wishing to take shares in a company in return for making an investment in a high risk business, but who does not wish their liability to exceed the amount of their investment.

Sometimes, though, business owners have little choice but to trade through a limited company. For example, a bank or venture capitalist backing a company may insist on incorporation as a condition of funding.

In order to preserve the benefit of limited liability, owners or investors should try to avoid the various commercial pressures and legal obligations which could negate this benefit. Examples include giving warranties to investors as to the state of the company and its underlying business, or personally giving a rent deposit or bank guarantee.

Directors and share-holders are often actively involved in the management of the company. In their dealings, they must ensure that they act lawfully and do not fall foul of legal requirements such as the Companies Act and the Insolvency Act. If they do, they run the risk of being made personally accountable to the company's creditors.

Setting up your business – part I

The basic structure

Another advantage of incorporation to investors is that a company can create a floating charge over its business and assets. This is something a partnership cannot do. A floating charge makes it easier to raise finance.

A limited company can also raise money by issuing share capital, including making an offer to the public and/or a flotation on the London Stock Exchange or the Alternative Investment Market. Again, this is something unique to limited companies and not available to sole traders, partnerships or LLPs.

Limited Liability Partnerships (LLPs)

Business owners can now choose a new type of company - an LLP. An LLP is a hybrid of a limited company and a partnership. To outsiders it is a legal entity of its own and subject to company law regulation. But to its members it is similar to a partnership, in that the members regulate its management by agreement amongst themselves, but without the structure of a company memorandum and articles of association, directors or shareholders.

The lack of this structure means that an LLP agreement is needed, along the lines of a partnership agreement, to spell out the rights and obligations of all the members. Members of an LLP can enjoy the protection of limited liability, in the sense that they generally have no direct liability for the obligations of the LLP entity. At the same time, they will benefit from the tax advantages available to ordinary partners of a partnership.

There is some doubt, however, about the extent of personal liability for any wrongdoing that a member may commit. It seems that LLP members who commit torts in the course of the firm's business may be personally liable in respect of them, while the firm is liable to the same extent as the member. In other words, the firm's liability is measured by the level of liability of the 'guilty' member.

In view of this, business owners should be aware that an LLP may not completely limit their personal liability for actions carried out in the course of carrying out their business.

Although LLPs were originally set up for the benefit of larger professional firms, over three quarters of registrations have been taken up by the wider business community. Perhaps this is because the LLP is a more sensible form for the smaller business run as a 'quasi-partnership' and which would previously have been run through a private limited company.

The main disadvantage of an LLP to many smaller business owners is the requirement to file accounts, prepared on a 'true and fair' basis, which are then made available to the public. And although the LLP structure was designed to give businesses flexibility, there is already some confusion caused by the fact that a mix of both company law and partnership applies to LLPs. There is no standard form of constitution as with limited companies, so an LLP would need to rely more on professional advice to put in place an LLP agreement between the members.

It remains to be seen whether LLPs will become a popular choice of business medium for SMEs, particularly after the reforms recommended by the Company Law Review in June 2001 have been implemented, which will simplify the law for smaller companies.

Legal formalities

As you might expect, there are more formalities involved in setting up and running a limited company or an LLP than trading as a sole trader or partnership. Since a company has a separate legal identity, it follows that it will have its own balance sheet of assets and liabilities. There will be little recourse for creditors if, on a winding up, there are more liabilities than assets.

Therefore, company law has developed detailed provisions to protect company assets, ensuring that any liabilities are properly incurred and determining the rights of creditors.

Legal procedures are laid down to ensure that a limited company's capital is not misappropriated or unlawfully reduced. There are also restrictions on making loans to directors, reducing the company's share capital, the redemption of shares, financial assistance for the acquisition of the company's own shares and restrictions on the payment of dividends and other distributions.

Note that these restrictions do not apply to LLPs, which do not have share capital and are taxed like a partnership

Setting up your business – part I

The basic structure

All companies must file accounts and annual returns, and all but sole traders must hold annual meetings. A company is obliged to ensure that its accounting records 'disclose with reasonable accuracy the financial position of the company at that time' (Companies Act 1985 section 221). These will require the employment of professionals to assist in compliance.

In contrast to limited companies, partnerships are not required to have their accounts audited, or to have records of the identity or address of the partners available for public inspection. As a limited company is a separate legal entity, it is unaffected by any change in the identity of its members, whereas a change of partners will terminate a partnership. Although in most cases the partnership will continue uninterrupted, technically it will continue as a different partnership.

Employee Incentives

In terms of offering incentives to employees, a limited company offers many advantages. It can create employee share ownership schemes, many of which have tax benefits for the employee attached to them. And the Companies Act contains suggested standard articles for a company whose shares are largely to be held by, or on behalf of, its employees. Share schemes approved by HM Revenue & Customs are the most tax efficient, although they may be less flexible than unapproved schemes.

The most common types of employee share schemes are: company share option plans (CSOPs); Save As You Earn (SAYE) schemes; Enterprise Management Incentives (EMI) schemes; and all employee share ownership plans (AESOPs).

These schemes are a useful way of attracting and retaining staff and enabling employees to benefit from the profits generated by the company. A flexible share structure can be set up to allow participation in unequal ways, by creating shares which carry enhanced dividend or voting rights. There are, however, complicated rules for disclosing share arrangements in the company's financial statements, and professional advice will be needed.

Employees of unincorporated businesses or LLPs can also be offered incentives through profit or performance related benefits. But this tends to be less flexible than share schemes for limited companies.

Extracting profits

The way business owners will extract profits from the business may affect how they decide to structure their business. In a corporate vehicle the choice is primarily between paying a dividend or taking a salary. This will depend on whether the owner is a shareholder, director/employee or both. The owner may also be remunerated in other ways, such as receiving a bonus issue of shares, a share option or pension contributions.

Where profits are distributed to shareholders, however, there is a danger that those profits will be subject to double taxation.

A partner may be remunerated through receiving a profit share or a salary, and again contributions can be made into his pension.

For further information, please contact

Alan Zeffertt az@lzwlaw.co.uk