

# WHY TRADE AS A LIMITED COMPANY?

*A PRACTICAL GUIDE*



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## WHY TRADE AS A LIMITED COMPANY?

Whether you are just starting up in business or are already established, you should give careful consideration to the legal status of your business activity.

The law allows those who wish to run a business to do so in a variety of different ways. A business may be operated by a sole trader, or two or more individuals may combine together to form a partnership, or a company may be formed to run the business. (Some businesses are co-operatives, but these are less common and will not be dealt with here.)

Each of these methods has advantages and disadvantages. Trading as a Sole Trader is the simplest, but you could be made bankrupt if your business fails. You will also find it hard to get personal or business loans (including mortgages) as a self-employed person (which is what you would be). If you do get loans the interest rate will almost certainly be higher than for someone who is an employee, ***possibly even one of your own employees!*** You may think it unfair that the “boss” is not such a good risk as the employee. You are right! Banks, and other financial institutions, rely on their own lending “profiles” and “credit scoring” systems, and self-employed people are not looked on favourably unless they have been in business for several years, and can offer proof that they are trading profitably and successfully. You could even find that steps taken by you, or your accountant, to reduce you tax liability, could rebound because lenders are only interested in your “taxable income”.

If you go into partnership with one or more other people you could find yourself in an even worse position than as a sole trader because you could be held to be personally liable for business debts and contracts incurred by your partner(s) ***even if you had no knowledge of them.*** You can take steps to safeguard yourself by having a solicitor draw up a detailed partnership agreement, but this will cost you several hundred pounds. In most cases of partnership lenders will still regard you as being self-employed, with the same problems in getting a loan. The recent introduction of Self-Assessment for income tax may also have a bearing on partnerships making it worthwhile them transferring all or part of their business into a Limited Company.

Trading as a Limited Company will overcome the problems you will face when trading as a Sole Trader or Partner. If a Limited Company fails you cannot be made to pay the business debts, you are safeguarded against partnership problems, without the need for a costly agreement, and you are regarded as an employee of the Company so you can present payslips and P60's to banks and other lenders as proof of your income. Even if you work on your own they will look on you in a much more favourable light and you need not tell them, unless they ask, that you are the owner and only employee, and there are ways round that question anyway! There is another advantage in trading as a Limited Company - ***Status and Prestige.*** As a Limited Company you present your business as a much more professional and established concern.

## THE DISADVANTAGES OF TRADING AS A LIMITED COMPANY

If it is all so advantageous why doesn't everyone trade as a Limited Company? Leaving aside the fact that the law insists that certain types of professionals, notably Doctors, Dentists, Solicitors, and Barristers, must either trade as sole traders or partnerships there really is no reason why any sort of business should not operate as a Limited Company. However to do so does need a little more paperwork and care than the other options.

A Company has to be formed and registered with the Registrar of Companies. This requires a lot of form filling and legal process has to be carefully observed in order to satisfy the Registrar that the Memorandum and Articles of Association of the Company (the legal basis for the company) are properly drafted and comply fully with the requirements of the Companies Act. There are several ways to form a company. You could do it yourself, but this requires a lot of knowledge and a lot of accurate typing. If you get it wrong the Registrar will refuse to register your company and you will have the inconvenience and expense of having to do it all again.

Of course, you could go to a Solicitor or Accountant and ask them to form a company for you, but the chances are they will employ a specialist agent like ourselves to do the formation, simply because we can do it at a much lower cost. ***Our staff have many years experience in forming companies and we will form a company in England, Wales or Scotland for only £75-00, and in Northern Ireland for £85.*** These prices are fully inclusive of costs, taxes and Government Fees (which are higher in Northern Ireland). There is no need to pay more - this is a high quality, professional package.

You might be put off by the rules and regulations about what information you have to show on letterheads, written orders, receipts, written demands for payment, and by having to send an Annual Return to the Registrar of Companies detailing any changes in share ownership or directors, and listing certain types of borrowing the Company may have made. Although this is a bit onerous, if you are reasonably well organised you will have no trouble complying with these requirements. When we register a company we provide a guide to help to keep you on the straight and narrow, but, if you prefer, our business administration department can, for a small fee, provide a Company Secretarial service and take charge of these demands freeing you to do what you do best - run your own business!

Until quite recently there was a much more serious disadvantage in carrying out business as a Limited Company. This was the requirement for ***all*** Limited Companies, ***whatever their size***, to have their accounts audited every year, and a copy of these accounts deposited with the Registrar of Companies. Until the 1990's the audit fee for a small company was around £250 to £400, but in 1989 the Audit Regulations were tightened up and all audits, now called "Statutory Audits", had to be carried out by Registered Auditors who have to do a lot more checking of the accounts, and keep a written record of the whole audit - their audits are themselves audited! Audit

requirements were the same for a small one-man company as for ICI, BP or a multinational company. After 1989 the cost of an audit escalated and even a small company could face a bill for £1,000 to £1,500 every year. Whilst there were good reasons why the Audit Regulations were tightened up, none of these applied to small companies. A Statutory Audit is really a report by the Auditor to the members (shareholders) to confirm that the company is well run, that the accounts are being kept properly, and that the directors are not defrauding the shareholders. In the case of most small companies the shareholders and directors are the same people, so all the Auditor does is tell them they are not defrauding themselves!

In 1994 the law was changed so that private (as opposed to public) companies with a turnover of less than £195,000 did not need a statutory audit. Over the years that figure has been raised and now private limited companies with a turnover of less than £5.6 Million need not have an audit and need only deposit a balance sheet with the Registrar together with a simple declaration from the directors as to its accuracy. In practical terms in order that the needs of banks and other financial institutions are met it is preferable that an Accountant draw up the accounts - but a costly audit is no longer required.

Notwithstanding the above there are some circumstances where companies with less than £5.6 Million will need to have their accounts audited. These include:

- a) Where the company has assets on the balance sheet of over £2.4 Million;
- b) Where the company is engaged in a regulated activity which requires an audit for reasons other than for the Companies Act (typically Independent Financial Advisors and other financial service activities);
- c) Where any member or members holding not less (in aggregate) than 10 per cent in nominal value of the company's issued share capital, or any class of it, make a written request that the company obtains an audit of its accounts for the current year. Such request must be made at least one month before the end of the current financial year; or
- d) If the Company is the subsidiary of another company which itself requires an audit.

## THE CHOICES IN MORE DETAIL

Before moving on we will examine the pros and cons of each type of business format in a little more detail. Please remember that when we are talking about a Limited Company the terms “member” and “shareholder” are the same. However an “investor” may or may not be a share-holder. Banks or other lenders may “invest”, but will probably want more security than shares!

### 1. SOLE TRADERS

Operating as a sole trader, either entirely alone or with employees, is the simplest way of starting a business. Anyone can set himself or herself up as a sole trader without going through any formalities. (But see Business Names below.) The sole trader has total control over his business, but he or she will be personally liable for all its debts if the business fails. This means that the assets used in the business, for example premises and stock, and *all* the trader's personal assets, including his or her house, may be sold to satisfy the business's debts.

### 2. PARTNERSHIPS

A partnership is defined in the Partnership Act of 1890 as “the relation which subsists between persons carrying on a business in common with a view to profit”. It follows from this definition that if two or more people are in business together, the law will treat them as a partnership regardless of whether they have formally entered into a partnership agreement, or indeed, whether or not they even realise that they are in partnership. The legal consequences which flow from being in partnership are many and complex, and it is outside the scope of this guide to deal with them at length, but the following should be borne in mind by anyone contemplating entering a partnership - *a partner may be made legally responsible for the actions of his fellow partners either under civil law or criminal law*. All partners will be held “jointly and severally” liable for all contracts and debts of the partnership whether or not they personally agreed with, approved of, or had knowledge of these. The debts of one partner, in respect of the business, can be recovered from one or more of the other partners. As distinct from the position of a shareholder in a limited liability company, the entire personal wealth of a partner is available to meet the partnership's obligations. If you are considering trading as a partnership consult a Solicitor.

### 3. LIMITED LIABILITY PARTNERSHIPS

This is a new structure which basically is a corporate partnership with limited liability. It answers the problems of partner liability and as a company is not itself liable to pay tax as its partners are liable on an individual basis. Please ask for further details.

#### 4. LIMITED COMPANIES

In Law a Limited Company is a separate legal entity and quite distinct from its shareholders or directors. There are three main types of Limited Companies which can be formed to trade in the UK: Private Companies Limited by Shares, Private Companies Limited by Guarantee, and Public Limited Companies. In general most UK Companies are formed to be limited by Shares and this is the type of Company we normally form on behalf of clients. We can form both “Private and “Public” companies “Public” companies *must* have a statutory audit, and *must* have at least £20,000 fully paid up shares They also cost more to form and administer. For those reasons most companies formed are “Private” but if you require more information on “Public” companies please contact us. Note that a “Private” Limited Company has the word “Limited” or “Ltd” at the end of its name, a “Public” one has “Plc”.

In a Limited Company the liability of shareholders is *limited* to the amount *unpaid* on any shares issued to them. This means that if a shareholder has paid for all the shares issued in his or her name, then he or she cannot be held personally liable for the debts of the Company. Creditors of a Limited Company can only look to the Company for payment, which must only be made out of company assets.

#### SUMMARY OF THE ADVANTAGES

- 1) Directors and shareholders are both insulated from liability for the debts of a Limited Company if it becomes insolvent. The only proviso to this, and other legal protection, is that the directors must have acted legally and in good faith. If a company has traded wrongfully or fraudulently then directors convicted of such offences lose the protection of financial limited liability, and may even be sent to jail. In short - don't set up a Limited Company with a view to fraud!
- 2) A company is a separate legal “person”. The company owns the business, its premises and all of its assets. The members (shareholders) own shares in the company and have no *direct* stake in the assets. The interest of a shareholder can be easily transferred without disrupting the running of the company. This makes it easier for members to join the company and indeed to leave it. There are fewer problems when a member dies or if he or she made bankrupt. Shareholders do not have to be individuals; one company can hold shares in another company.
- 3) Surprisingly, despite the fact that the liability of shareholders for a company's debt is limited, it is often easier for companies to raise loan finance. This results in part from the reluctance of financial institutions to lend to private individuals, and also because the assets of the company are themselves protected. Companies can also offer various types of security; shares, debentures, floating charges, that individuals and partners cannot. However, please note that Banks and other lenders are likely to ask directors of Limited Companies established for less than three or four years to give a personal guarantee for loans or overdrafts.

- 4) A Limited Company is liable for tax on its profits. This is payable by the Company, not personally by the directors or shareholders. The profits of a Limited Company are not subject to higher rates of personal income tax. This is of particular advantage to contract workers (Engineers, Designers, etc). Directors' salaries become their personal property on payment, and cannot be claimed by the Company's creditors (anyone they owe money to). Directors pay tax on their personal income, but are entitled to the normal personal allowances against such income and can often claim expenses not allowable to sole traders. A Limited Company pays Corporation Tax at 24% on its profits up to £300,000, with a progressive rate after £300,000 up to £1,500,000, when the rate becomes 33%. (Note that an individual pays 40% over £25,500.) The company is taxed on profits after all expenses, including directors' remuneration, have been deducted. Companies can claim many allowances and reliefs against profits not open to sole traders or partnerships.
- 5) As an employee, even of your own Limited Company, lenders will often look more favourably on you if you want a mortgage or any type of credit.
- 6) You can transfer an existing business, its stock, assets etc into a Limited Company.

## WHAT NEXT?

Having decided that you want to trade as a Limited Company all you need do is fill in the forms that accompany this booklet and send us your remittance of £75 (£85 if you want your Company registered in Northern Ireland) by cheque or postal order. Unlike many formation agents we do not keep large stocks of ready made companies for transfer. We feel that there is no real advantage in purchasing a ready made company with a name that may, or more likely may not, suit you. If you buy a company with a name like Glurgleglog Ltd you are going to want to change the name or trade under some other business name. If you change the name it will take just as long, and cost just the same, as having a company formed and registered in a name of your own choice. If you trade under a “business name” it will be obvious to everyone that you have bought a “ready made” company and you will lose some of the prestige element of trading as a Limited Company. In business image means a lot. What is the point in buying an “off the shelf” company when we can form and register a company with your choice of name within (normally) seven working days? (For an extra charge of £280 we can form a company in *one* day!) However, we do keep one or two “stock companies” should you really need one instantly.

Before you fill in the forms that accompany this guide, please read the following for your guidance and information.

## COMPANY NAMES

When choosing a company name it is particularly important that persons forming companies should satisfy themselves in advance of the acceptability of the proposed name to the Registrar of Companies. Although we check the availability of a name before applying to register it you should understand that a company will not be registered if:

- a) it wants to use a name already appearing on the Index of Company names maintained by the Registrar;
- b) it contains the words “Limited” “Unlimited” or “Public Limited Company”, or their Welsh equivalents, or abbreviations of these words, except at the end of the name;
- c) in the opinion Secretary of State it is offensive;
- d) in the opinion of the Secretary of State its use would constitute a criminal offence.

In addition the approval of the Secretary of State is required before a company may be registered by a name which would be likely to give the impression that the company is in any way connected with Royalty, HM Government, a local authority, or contains a word or expression specified in various “Regulations”.

Certain names are not accepted for incorporation under “Regulations” without justification. The following is a *partial* list of such words:

- a) Words which imply national or international pre-eminence: International, National, European, United Kingdom, UK, Great Britain, GB, British, England, English, Scotland, Scottish, Wales, Welsh, Ireland, Irish.
- b) Words which imply governmental patronage or sponsorship: Authority, Board, Council.
- c) Words which imply business pre-eminence or representative status: Association, Society, Federation, Institute, Institution.
- d) Words which imply specific objects or functions: Assurance, Insurance, Reinsurance, Reassurance, Insurer, Assurer, Re-assurer, Reinsurer, Patent, Patentee, Co-operative, Stock Exchange, Bank, Chamber of Trade, Chamber of Industry, Chamber of Commerce, Chemist, Chemistry, Optician, Optometrist, Group, Holding, Post Office, Giro, Trust, Benevolent, Register, Registered, Friendly Society, Industrial & Provident Society, Building Society, Trade Union, Foundation, Fund, Charter, Chartered, Sheffield.

If you wish to use any of the above words in your company name please contact us so we can tell you what evidence we need to present in order to gain approval. For example, if you wish to register a company called XYZ International Ltd we would need to see evidence that you carried out, or will be carrying out, business in at least two other countries. This does not simply mean selling things overseas, but having “a presence” (offices or agents) overseas.

Although a name will not be registered where it is the *same* as that of an existing company a *similar* name *will* be registered. Even if the Registrar accepts your name there is the risk that, within 12 months of registration, you may be directed to change the name if a pre-existing registered company presents a justifiable claim that your name is “too similar”, is “liable to cause confusion”, or is in some other way a breach of their legal rights.

## **BUSINESS NAMES**

Business names are regulated by the Business Names Act 1985. A sole trader or partnership trades under a business name if a name other than the surname and forenames or initials of the proprietor or proprietors is used. You can trade as “John Smith, Butcher” (if your names *is* John Smith) or as “J. Smith, Butcher”. You cannot call yourself “Smith The Butcher”, or “Smiths Quality Butchers” without complying with the Business Names Act. A Company has a business name if it trades under a name which is in any way different from its registered name. The use of some names is prohibited in the same way as for “Company Names” above. Whilst a company name is exclusive, a business name is not. We will send you a leaflet explaining the Business Names Act free on request when you order a company from us.

## **SHAREHOLDERS**

As you would expect, Companies Limited by Shares must have shareholders. A Private Limited Company must have at least one shareholder, preferably two. Shareholders, unless they are also Directors, are not liable for any mismanagement of the company and are only liable for any unpaid amount due on shares issued to them. In the event of liquidation shareholders will only be required to pay any unpaid amount due on shares they hold. If their shares have been fully paid up then they will be required to pay nothing. Do not confuse “Issued Shares” with “Authorised Share Capital”. We normally form companies with an “Authorised Share Capital” of £1,000 divided into 1000 shares of £1, but this does not mean that the company has issued 1,000 shares. For example, Glurgleglog Ltd could have an “Authorised” share capital of £1,000. It could have two shareholders one of whom has agreed to purchase 100 shares but only paid for 50. If the company fails he or she would only have to pay only £50 being the value of issued but unpaid shares. The other shareholder agreed to purchase 25 and paid for them if full. If the company fails he or she would not have to pay any money. In fact some companies with authorised share capitals of £10,000 are operating with issued shares of only £2. The Walt Disney Company Ltd has an authorised, and fully paid up, capital of just £100!

## **DIRECTORS & COMPANY SECRETARY**

Every Private Company must have at least two “officers”, one of who must be a director and one the Company Secretary. A Company Secretary isn’t someone who types letters but someone who is responsible for ensuring that the company complies with the legal requirements of the Companies Act. A person can hold office as both director and secretary providing there is at least one other director. An undischarged bankrupt or a person subject to a disqualification order under section 295 of the Companies Act 1985 cannot be a Director or be concerned with the information, promotion or management of a company. The Directors, and Secretary, as officers of the company, must act responsibly, in good faith, and in the interests of the shareholders.

## **REGISTERED OFFICE**

Every company registered in Great Britain must have a Registered Office in Great Britain at which, if necessary, legal documents can be served. A company's Memorandum will state whether the Registered Office is to be situated in England, Scotland, Wales or Northern Ireland. Companies who wish their Registered Office to be in England or Wales will be registered at Companies House in Cardiff. Companies who wish their Registered Office to be in Scotland will be registered at Companies House in Edinburgh, and N. Ireland Companies in Belfast. The Registered Office need not be where the company will carry on business, it is simply the "legal" address of the company. If you do not wish to use your home address, or place of business, as your Registered Office, we are able, for a fee, to provide Registered Office addresses in various locations. Please ask for details.

## **MEMORANDUM AND ARTICLES OF ASSOCIATION**

These are the rules and regulations forming the legal basis for the conduct of the Company between third parties, shareholders and directors. The "Memorandum" of companies which we form is drafted in such a way so as to provide a company with unlimited powers to carry on any business and to raise finance. More specific clauses are available if required.

## **AUTHORISED SHARE CAPITAL**

Companies are most frequently formed with an authorised share capital of £1,000 divided into shares of £1 each. There is no legal maximum or minimum amount of authorised capital. Neither do you have to have shares valued at £1 but at any figure you like. You can even have different "classes" of shares, such as "A" or "voting" shares valued at £1, and "B" or "ordinary" shares valued at 10p. For most circumstances we advise you form a company with one class of share valued at £1. If you later wish to have other classes or value of share this can be arranged for a nominal fee. Although we normally form companies with an authorised share capital of £1,000 a larger or smaller share capital does not incur extra formation costs.

## **WHAT YOU HAVE TO DISCLOSE WHEN TRADING**

A Limited Company must show *legibly* on all business letters, written orders, invoices, receipts, and written demands for payment, the Company's registration number and name, and the Registered Office address. It is not necessary for director's names to appear. However, if the name of *any* director does appear (except in the text of the letter or as a signatory) the names of *all* directors must be shown. This information must also be displayed in any premises where the business is carried on, and to which customers and suppliers have access. There is no need to mention the authorised share capital of the company but if you do you also have to say how much is paid up - so don't mention it!

## FORMING YOUR NEW COMPANY

Subject to availability, we will form a company with the name of your choice. You will have to have at least one other person willing to act as a Director and/or Company Secretary. There are two ways we can form your *Custom Formed* Limited Company:

**Standard** We register the new company with our Nominee Director and Company Secretary and on registration they resign to be replaced by the people of your own choice. This gives you longer to get forms etc signed.

**Special** We register with your own details as Secretary and Director(s). As the Director(s) and Secretary must sign the initial forms if, for any reason, this will cause you a problem or delay, then choose the previous option:

In order to facilitate speedy formation of your company, Ashburton Registrars Ltd will act as joint Company Secretary to make the Declaration of Compliance before a Commissioner for Oaths. On registration we immediately resign to be replaced with the Company Secretary of your choice. We provide two nominee subscribers who agree to purchase one share each in the new company. On registration these shares are transferred to the new owners.

We supply you with your Certificate of Incorporation, four bound copies of the Memorandum and Articles of Association, share transfer forms, Personalised Share Certificates printed on “parchment” paper, our comprehensive guide to running your new company, draft minutes of the first and second meetings, a Combined Register & Minute Book, etc. Since 1989 Limited Companies have not been required to use a Company Seal. However, if you wish your company to use a seal (though there is no real reason to do so) we can supply a seal at an extra charge. For other services likely to be of use please see Appendix “B”.

## THE OFFSHORE OPTION

To the uninitiated, the world of offshore companies conjures up an exciting, if not slightly illicit, cocktail of millionaires, exotic locations and scantily clad females. That this is rarely the case, hardly seems to matter. What does matter, however, is that it is *often* possible for the international entrepreneur to arrange his or her personal and business affairs to genuinely and legitimately mitigate their worldwide tax position.

AR Corporate Secretaries Limited offer offshore services in more than 40 jurisdictions however 99% of those who enquire would be far better off with a UK company. These people have been told, probably by “bar-room experts”, that “going offshore” will save them tax. In fact not only would there be no tax saving, there could be a higher liability than by simply using a UK company.

There is a well know case of a Mr Brackett who was “advised” to set up a company in Jersey through which to operate his business. The idea was simple enough; Mr Brackett would work for the Jersey Company and be paid a modest salary, but all the income from his work in the UK would be paid into the Jersey Company, where it would be free of Jersey Tax. It was quite true: there was no liability to Jersey tax (though he had to pay “management fees” of £900 a year) but unfortunately the plan stood no chance of saving UK tax; indeed quite the reverse! The tax rules were more than sufficient to allow the Inland Revenue to charge Mr Brackett tax *personally* on the whole of the company’s income. Furthermore, there was no good reason why his salary should not continue to be taxed under PAYE, even though it was derived from the same income, and to make matters even worse, the Jersey company could also be charged UK corporation tax.

You see, for taxation purposes it is “residence” that matters, for a company that is the country where the *management and control* takes place. This is deemed to be the place where the majority of the directors reside and hold their meetings, but this “residence” may be influenced by the place or places of business created by the company. For example, if the directors are resident in the United Kingdom then the company will certainly be subject to United Kingdom taxes. However, if the directors are resident in different countries the company will not incur a liability to tax on its world trading profits, but profits will be subject to tax in the countries where it has a permanent place of business.

Despite the forgoing, offshore companies and trusts have a multitude of potential uses and can an invaluable tool for the professional tax planner. However, it must never be forgotten that there are no standard panaceas. A persons’ nationality, type of business, residence and individual objectives - together with many other factors - will all greatly influence the advice given. For example, the establishment of a discretionary trust may be the ideal instrument for a resident of a civil law jurisdiction but a nightmare for an individual or company in a common law area such as Britain. Likewise, a company with customers in Country “A” rather than Country “B” could have totally different tax treaty ramifications. Different tax authorities also tend to have widely varying rules and regulations as to what is and what is not permissible. ***Please telephone 01952 270270 to discuss.***