

*A Practical Guide:***WHY TRADE AS A LIMITED COMPANY?**

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**INTRODUCTION**

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

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. Neither will we consider Community Enterprise Companies as these have specific not-for-profit uses.)

Each of these methods – sole trader, partnership or company - 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 harder to get personal or business loans (including mortgages – particularly in the present state of the economy).

As a self-employed person (which is what you would be) even if you do get loans the interest rate will 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 probably right! However 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”. I have lost count of the number of people who have come to me for advice on how to cut their tax bill who are astonished when I show them that they could end up paying more in extra interest than they save in tax.

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*. But worse, you could even be held liable for criminal actions of which you had no knowledge or no control over. 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 BASIC ADVANTAGES OF TRADING AS 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 then unless you have acted illegally you cannot be made to pay the business debts. You are safeguarded against partnership problems, without the need for a (potentially) more expensive partnership 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 then they are likely to look on you in a much more favourable light. You may not even need to tell them that you are the owner and only employee.

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

So, 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 isn't particularly difficult if you know what you are doing, but if you don't then you can run into a lot of problems. It is in fact quite easy to register a company – and it will become easier once the 2006 Companies Act is finally fully enacted in October 2009 – but although you could do it yourself I would strongly advise you to get a reputable Company Formation Agent to do it for you. Unfortunately it isn't as easy as it used to be to find a *reputable* agent these days. Five years ago if you searched Thomson or Yellow Pages you would have found about 60 agents. 10% of these accounted for 90% of formations. However nowadays you will find about 600 businesses claiming to be registration agents.

Unfortunately anyone can set himself or herself up as a formation agent even if they have no knowledge or understanding of company law. Until Companies House (the “trading name” of the Registrar of Companies) got into online filing in a big way, it wasn't attractive for anyone who didn't understand the process to get into the formation business. Now almost anyone can subscribe to basic formation software and can register companies but unless they understand what they are doing – and believe me few do – they can cause severe problems for you and your business. I could provide a catalogue of cases here that would make your hair curl and which caused major problems that I've had to sort out for people.

So, don't be “penny wise, pound foolish” as my mother used to say. Yes you can get companies formed for £20 or £25 but given that the fee charged by Companies House for an electronic formation is £15 you are not going to get much by way of service or paperwork from an agent charging you such a low price. ***You can get companies formed by professional and qualified agents for between £60 and £160. If you buy a “cheap” option you could end up paying someone like me an awful lot more to sort out the mess.***

OK. Lets assume you have used a reputable agent so let's have a look at some other potential disadvantages of trading as a limited company.

You might be put off by the rules and regulations about what [information you have to show on letterheads, websites, emails](#) etc, 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. There are plenty of guides around that will keep you on the “straight and narrow”. Have a browse on our websites, details of which are at the end of this guide, as a starting point. Or you could pay your accountant or a Chartered Secretary to do this for you, leaving you free to do what you do best - run your own business!

Many people hesitate to trade via a Limited Company because they believe that the accounting requirements are much more onerous. This used to be true. Indeed until 1994 every company, no matter how small, had to have a “statutory audit” carried out by a registered auditor. That was quite a problem but since then changes have been made so that now “small companies” (defined as having a turnover less than £6.5 million, a Balance Sheet of less than £3.26 million, and less than 50 employees) do not need an audit. Indeed companies don't even need an accountant – but unless you are very small you would be well advised to have an accountant to advise you even if you do most of the bookkeeping and accounting work yourself. But trading as a limited company needn't cost you much more than it would if you traded as a sole trader. For further information on tax and accountancy issues please see our guide [Accounting & Taxation for Small Businesses](#).

However, please note that even small companies will need to have their accounts audited in the following circumstances:

- a) 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);
- b) 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
- c) If the Company is the subsidiary of another company which itself requires an audit.

## THE CHOICES IN MORE DETAIL

Before moving on let's 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 shareholder. 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 other than informing Her Majesty's Revenue & Customs (HMRC). (But also see Business Names below.) The sole trader has total control over his or her 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 debts of the business. For information on tax and accountancy issues please see our guide [Accounting & Taxation for Small Businesses](#).

### 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. You should still consider a partnership (including a Limited Liability Partnership) but you are strongly advised to consult a Solicitor and make sure you enter into a proper Partnership Agreement.

### 3. LIMITED LIABILITY PARTNERSHIPS

This is a fairly new structure which basically is a corporate partnership with limited liability. It answers the problems of partner liability and unlike a company an LLP is not itself liable to pay tax,

as its partners are liable to account for their share of the profits on an individual basis. This is called being “tax transparent”.

The formation of LLPs was established by the Limited Liability Partnership Act 2000, which came into force on 6th April 2001. It was introduced to address the problem of unlimited liability of professional firms, such as solicitors and accountants. Over the previous decade or so claims for negligence against such firms had increasingly exceeded a firm’s professional indemnity insurance leaving the partners jointly liable for the full claim. In some cases this led to personal bankruptcy or at the least a huge personal payment from partners. This was particularly galling in the case of a large or multi national firm where partners are held responsible for the errors of people over whom they had no control and possibly had never even met!

You might think “why didn’t they form into a limited company” but certain professions are not allowed to do this and so the partners were left exposed and even if they could there could be serious tax implications for them.

So the UK introduced Limited Liability Partnerships (which existed for many years in other countries) giving them a corporate identity (that means they are a legal “person” like a company) but unlike an ordinary partnership an LLP can own assets in its own name.

The, probably unintended, tax advantage of an LLP is that being tax transparent it is a very efficient structure especially where there are non UK resident partners who may be able to avoid UK tax and only pay tax at a lower rate elsewhere. For example in the Isle of Man the standard rate of corporate tax is zero percent and the standard rate of personal tax is just 10%. An Isle of Man company which was a member of a UK LLP would therefore pay no tax at all on its profits from the partnership. No corporation tax in the UK – because it isn’t a corporation – and no tax in the Isle of Man because the rate here is zero percent. All legal. All above board. Introduced by Gordon Brown.

#### 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. Most UK Companies are formed to be limited by shares as those limited by guarantee are unable to distribute profits and are most often used for charitable purposes.

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; any 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. The main rate of Corporation Tax is 28% but a lower rate of 21% is payable on profits up to £300,000 with a system of relief for amounts over £300,000 but under £1.5 million.
- 5) The company is taxed on profits after all expenses, including directors' remuneration, have been deducted. Companies can claim many allowances and reliefs against profits which are not open to sole traders or partnerships. For further information on tax and accountancy issues please see our [Accounting & Taxation for Small Businesses](#).
- 6) 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.
- 7) You can transfer an existing business, its stock, assets etc into a Limited Company so even if you start your business as a sole trader you can later become a company. However it isn't so easy for a company to change into a sole trader.

### **OTHER CONSIDERATIONS**

Having decided that you want to trade as a Limited Company there are some other issues you should be aware of.

### **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. 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. For a complete list and a much more detailed explanation please download this [Guide to Company Names](#):

- 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, Government, 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 you will need to provide evidence to justify the use of the name. Sometimes this is fairly simple but sometimes it is rather complicated, if not impossible.

Let me give you three examples of problems I encountered when I was owner of a company formation agency.

- 1) We were asked to form a company called “The New Queen’s Hall Orchestra Limited”. Because it had the word “Queen’s” in the name we had to get approval from the Home Office. We wrote to the person responsible at the Home Office to explain that this company was being set up on behalf of the management of the New Queen’s Hall in Croydon. If you don’t know, there has been for many years a concert hall in Croydon (South of London) called “the Queen’s Hall”. About 10 years ago a new, larger and improved concert hall was built and opened by Her Majesty Queen Elizabeth. This new company was to be used to manage the resident Orchestra. We supplied a letter from the Queen’s Private Secretary saying that HM had no objection – indeed the hall was dedicated to her Jubilee. You would have thought that would be enough. But no. The jobsworth at the Home Office refused to approve the name on the grounds that it “implied a connection with the Royal Family”! Well of course it did you Muppet – *it had a connection with the Royal Family*. Not only was the Queen it’s Patron there were members of her family intended to be on the board of directors.
- 2) On another occasion we were asked to register a company called “The British xxxxxx Institute”. This was to be a medical research charity. We were advised that it wouldn’t be approved unless we could supply evidence to show that the directors were “pre-eminent in their field”. We sent CVs for the directors all of who were medically qualified academics of the highest reputation working in UK universities. We were asked to provide references from the head’s of their faculties. All were in fact head’s of their faculties. We were asked to provide references from internationally respected experts. Two of the proposed directors had Nobel prizes and there was no one better qualified than them. You guessed it. Application

refused. Of course we got around that by setting the company up with more junior staff as directors each having their heads of department write them a reference. Then they resigned and the people who gave the reference – but were not acceptable because there was no one better qualified to give them a reference – took their places. Daft.

- 3) We were asked to set up a company called “xxxx Bank Off-licence Limited”. Yep. We had to get permission from the Bank of England. Xxxxx was the name of the street the shop was situated in, like: “Tan Bank” or “West Bank” or “North Bank”. You get the point I’m sure.

*Important Note:* 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 by the [Company Names Adjudicator](#) 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. Read our guide to the [Business Names Act 1985](#) for further details.

## **SHAREHOLDERS**

As you would expect, Companies Limited by Shares must have shareholders. A Private Limited Company must have at least one shareholder. 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”. It is common to 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, Your Company Limited 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 share capital of just £100 of which, last time I looked, just £26 were issued. (I don’t think anyone would consider them to be a Mickey Mouse company!)

## **DIRECTORS & COMPANY SECRETARY**

Under the 1985 & 1989 Companies Acts 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, Health & Safety and various other matters. A person can hold office as both director and secretary only if there is at least one other director.

The 2006 Companies Act now allows private limited companies to dispense with having to have a Company Secretary, so it is now possible to have just one director and no one else. However it is not automatic that companies established under the 1985 or 1989 Acts can dispense with having a

Company Secretary and such companies may have to amend their Articles of Association. Read our [Guide to the 2006 Companies Act](#) for more information.

An undischarged bankrupt or a person subject to a disqualification order under the any of the Companies Acts cannot be a Director or be concerned with the formation, promotion or management of a company without approval from the courts. The Directors, and Secretary, as officers of the company, must act responsibly, in good faith, and in the interests of the shareholders. If they do not they could be held personally liable for the debts of the company and/or be prosecuted in the criminal courts.

## 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. 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, the registration agent or your accountant may be able to provide this service for a fee.

## MEMORANDUM AND ARTICLES OF ASSOCIATION

Currently these are two separate documents. The Memorandum sets out what the company can do (its “aims and objectives” and what its share capital will be. The Articles are the “rule book” setting out how it will be managed and how it will achieve its aims and objectives. From October 2009 companies established under the 2006 Companies Act will only have one document to be called “the Articles of Association” which will combine both documents – the Memorandum and the Articles. Companies established before October 2009 will retain both unless they vote to adopt one new all-encompassing document. Read our [Guide to the 2006 Companies Act](#) for more information.

## 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. This is also now required on websites and emails. It is not necessary for directors’ 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!

Read our [Guide to the Disclosure Requirements](#) for further details, and also have a look at our [Guide to the Business Names Act 1985](#) as many of these disclosure requirements also apply to partnerships and sole traders.

We hope you find this guide of value. Please visit our websites and blogs which are listed below on a regular basis as we post regular updates and information. This is the 20<sup>th</sup> edition of this guide which was first published in 1989.

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