

New Business Kit

The Financial, Tax and Accounting considerations of starting a new business

With this handy reference guide to starting a business, you should be able to successfully handle many of the problems encountered in starting and running a business. Always remember to seek professional advice in areas that you are not sure about. The benefits will far outweigh the cost. Good luck!



Before Starting Up

It is the ambition of many people to run their own business often to fulfil a desire to be more independent and to obtain the full financial reward for their efforts.

Whatever the reason, a number of dangers exist.

A major concern must be the risk of business failure despite considerable effort and finance having been put into the venture. Time spent in making the decision and thinking through your plans will minimise the risk of failure.

Think carefully about ceasing to be someone else's employee. Certainty of income, both in terms of quantity and regularity, disappears, whilst fixed outgoings, such as mortgage repayments, remain. Similarly, other benefits of employment may be lost, such as life assurance cover, a company pension, medical insurance, a company car, regular hours and holidays.

Consider the views of your family and friends. Their support is essential. It is important they understand that the administrative and financial requirements of running a business can be time consuming and stressful.

Success in business depends on many factors; most important is the need to critically review all aspects of the business proposition before progressing too far.

This kit highlights many of the practical points that require consideration before trading begins. It cannot cater for every possibility and decisions should be supported by appropriate professional advice.

Please Note

This kit is published for information only. It provides only an overview of the regulations in force at the date of publication, and no action should be taken without consulting the detailed legislation or seeking professional advice from a partner of this firm. No responsibility for loss occasioned by any person acting or refraining from action as a result of the material contained in this kit can be accepted by the firm, its directors or employees.

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Chapter 1 - Selecting a Legal Entity for your Business

One of the first major decisions you will have to make as you start your new business is the form of legal entity it will take. To a large degree, this decision may be dictated by the way you have organised your operations and whether you intend to work on your own or in conjunction with others.

The form of entity you choose can have a significant impact on the way you are protected under the law and the way you are affected by taxation rules and regulations. There are four basic forms of business organisation. Each has its own benefits and drawbacks and is treated differently for legal and tax purposes.

Sole Proprietorship

A sole proprietorship is typically a business owned and operated by one individual. A sole proprietorship is not considered to be a separate legal entity under the law, but rather is an extension of the individual who owns it. The owner has possession of the business assets and is directly responsible for the debts and other liabilities incurred by the business. The profit or loss of a sole proprietorship is combined with the other income of an individual for income tax purposes.

A sole proprietorship is perhaps the easiest form of business to own and operate because it does not require any specific legal organisation, except, of course, the normal requirements such as licenses or permits. A sole proprietorship typically does not have any rules or operating regulations under which it must function. The business decisions are solely the result of the owner's abilities and judgement.

Partnership

In a partnership, two or more individuals join together to run the business enterprise. Each of the individual partners has ownership of company assets and responsibility for liabilities, as well as authority in running the business. The authority of the partners, and the way in which profits or losses are to be shared, can be modified by the partnership agreement. The responsibility for liabilities can also be modified by agreement among the partners, but partnership creditors typically have recourse to the personal assets of each of the partners for settlement of partnership debts.

The rights, responsibilities and obligations of partners are typically detailed in a partnership agreement. It is a good idea to have such an agreement for any partnership.

A partnership is a legal entity recognised under the law and, as such, it has rights and responsibilities in and of itself. A partnership can sign contracts, obtain trade credit and borrow money. When a partnership is small, most creditors require a personal guarantee of the general partners for credit.

A partnership is also required to file an income tax return. A partnership typically does not pay income tax; the information from the tax return is combined with the personal income of the partners to determine their overall tax liability.

Limited Liability Partnership

The Limited Liability Partnerships Act 2000 change created a new type of business entity, the Limited Liability Partnership ("LLP"). The LLP offers limited liability to its members but is tax transparent and offers flexibility in terms of its internal organisation.

An LLP is a separate legal entity from its members. Therefore, it may enter into contracts and deeds, sue and be sued and grant floating charges over its assets in its own name. This avoids the problems

that exist in relation to partnerships, where technically it is often necessary for every partner to be party to certain documents or litigation, and the creation of floating charges is not possible.

The members of the LLP are those persons registered at Companies House as members.

The main "price" paid in return for limited liability is public availability of financial statements. An LLP must file audited accounts (prepared on a "true and fair view" basis) annually at Companies House, which must include the name and profit share of the highest paid member.

In addition the LLP must also file details of the name and address of every member at Companies House. At least two members must be "designated members" responsible for making proper filings at Companies House (and subject to penalties in the event of default).

Provided an LLP carries on a trade or a profession and is not simply an investment vehicle it is tax transparent – that is the LLP itself is not taxed on its income or capital gains at all. Instead the members are taxed on their shares of the LLPs' profits and gains, just as partners in a partnership are currently taxed.

This means that the LLP may be more tax efficient than a limited company. This is because ordinarily a limited company is taxed on its income and capital gains and the company's shareholders are taxed on distributions from the company to them, giving rise to potential double-taxation.

LLPs were primarily intended for use by the professions. However, any type of business operating for profit may use LLPs. An LLP may be suitable for use as a joint venture vehicle or as an alternative to a limited company, particularly for small businesses.

Limited Company

A limited company is a separate legal entity that exists under the authority granted by statute.

A limited company has substantially all of the legal rights of an individual and is responsible for its own debts. It must also file tax returns and pay taxes on income it derives from its operations. Typically, the owners or shareholders of a limited company are protected from the liabilities of the business. However, when a limited company is small, creditors often require personal guarantees of the principal owners before extending credit. The legal protection afforded the owners of a limited company can be useful.

A limited company must obtain approval from Companies House to use its proposed name. A limited company must also adopt and file a Memorandum and Articles of Association, which govern its rights and obligations to its shareholders, directors and officers.

A limited company must file annual tax returns ("corporation" tax returns) with H M Revenue & Customs.

Incorporating a business allows a number of other advantages such as the ease of bringing in additional capital through the sale of share capital, or allowing an individual to sell or transfer their interest in the business. It also provides for business continuity when the original owners choose to retire or sell their shares.

Should you decide to incorporate your business venture, you should seek advice from CKLG.

We can also assist in forming the company through our appointed agents.

Business Structure – The Pros and Cons

Company	Sole Trader/Partnership
A company must be formally incorporated with a written constitution in the form of a Memorandum and Articles of Incorporation. There is, therefore, an initial setup cost.	There are no formation costs, but a written partnership agreement is advised.
Companies are governed by the Companies Acts. A company must: <ul style="list-style-type: none"> - Keep accounting records - Produce audited accounts (if turnover > £6.5m) - File accounts and an Annual Return with the Registrar of Companies. This information is available to the public. - Keep Statutory Books 	Sole traders and partnerships are not required by law to have annual accounts nor to file accounts for inspection. However, annual accounts are necessary for the Inland Revenue tax returns.
Companies may have greater borrowing potential. They can use current assets as security by creating a floating charge.	Sole traders and partners are unrestricted in the amount and purpose of borrowings but cannot create floating charges.
Shares in a company are generally transferable – therefore ownership may change but the business continues.	
Incorporation does not guarantee reliability or respectability but gives the impression of a soundly based organisation. Personally, there may be prestige attached to directorship.	The unincorporated business does not carry the same prestige.
Tax is payable on directors' remuneration paid via PAYE on the 19th of the following month. If applicable, higher rate tax is paid by shareholders on dividends under the self-assessment rules. Corporation tax is payable 9 months after the year-end.	For a sole trader or partnership, tax is generally paid by instalments on the 31 January in the tax year and the 31 July following the tax year. Tax for 2010/11 is payable:- first payment on account on 31 January 2011, second payment on account on 31 July 2011, with any final balance due on 31 January 2012.
Losses in a company can only be carried forward to set against future profits.	Losses generated by a sole trader or a partner can be set against other income of the year or carried back to prior years.
For profits up to £300,000 tax is charged at 20% (2011/12)	Profits are taxed at 40% on taxable income in excess of £35,000 and at 50% over £150,000 (2011/12)
There is both employers' and employees' national insurance payable on directors salaries and bonuses. The NI charge is greater than that paid by a sole trader/partner.	A partner/sole trader will pay Class 2 NI of £2.50 p.w. and Class 4 NI dependent on the level of profits.