BUILT ON ROCK

THE BUSY ENTREPRENEUR'S LEGAL GUIDE TO START-UP SUCCESS

MICHAEL BUCKWORTH

Michael Buckworth has written a must-read primer for anyone considering setting up a business. Read this book, and learn from one of the best.

Duncan Cheatle – Co-founder of StartUp Britain, founder of Learn Amp and The Supper Club (home to hundreds of the UK's most successful founders)

There are so many things founders have to get right in the first few months of their start-up's life, and the fear of getting something wrong can hold back even the most enthusiastic entrepreneur. *Built on Rock* explains what you should and shouldn't do, and is your best friend as you navigate the legal and business challenges of your new business. This is the book that will get ideas out of your head and turn them into a start-up.

Mirela Yordanova – Associate, LaunchLab Ventures

Michael Buckworth takes the reader on an educational journey from incorporation through launch and ending on raising an investment round. This is a must-read guide for students of entrepreneurship and anyone who wants to get a handle on the legal issues to think about when setting up a business.

Jerry Allen – Director for Entrepreneurship, UCL Innovation and Enterprise, Director of Enterprise Educators UK, Advisor to the UN

Built on Rock is written by one (legal) entrepreneur for another. However, forget legal speak, long words and complex explanations: this book focuses on what matters and gives practical advice on how to approach challenges. If you confuse your pre and post money, or think that fully diluted relates to the amount of ice in your G&T, this is a book you simply must buy.

Mark Tayler – Director, SFC Capital

Setting up a start-up can feel incredibly risky, particularly for young entrepreneurs. *Built on Rock* explains in simple terms how to identify and manage the legal and business risks inherent in a new business, without breaking the bank.

Jack Parsons – UK's Chief Youth Officer

Lawyers who can explain complex issues simply are few and far between: Michael Buckworth is one of them. *Built on Rock* brings Michael's in-depth knowledge of business and law, and over a decade of experience working with and helping entrepreneurs thrive in business. This is an essential guide for ambitious founders who want to set up in business, or take their existing start-up to the next level.

Chris Hancock – Founder of Crowd2Fund

Setting up a business is difficult with lots of pitfalls, but it's not rocket science. In this book, Michael demystifies the business and legal aspects by explaining in simple terms what founders should be most concerned about, and what they can sensibly decide to worry about later. This book is full of tips and advice drawn from Michael's work with many start-ups: every reader will discover something they didn't realise they didn't know.

Paul Grant – Founder of The Funding Game

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Chapter 1

Setting up your company

Avoid the barriers and traps

You have an idea for your new business. You might even have tested it out, started exploring how you're going to fund it, and brought some co-founders on board to help you make it a success. It's an exciting time.

And yet it's also the moment at which you might feel a bit stuck. Do you set up a company, and if so what kind? Should you raise investment at the beginning, or wait until later on? Is it a good idea to plan out the finances up front, or to see how things evolve? And out of the myriad things you have to do, what should you focus on first? It can feel overwhelming.

I speak to lots of entrepreneurs who are at this stage, and what I find time and again is that it's easy to let the technicalities of setting up your business distract you from your main goal: to start creating your product or service and making money from it. I call them the 'Four Barriers'.

The Four Barriers

Barrier #1: worrying about what legal structure to use

Sometimes people spend months researching whether they should create a limited company, a social enterprise structure, or some other kind of entity. Please don't waste time on this. If you're in any doubt just set up a limited company, and you can always change it later – it's flexible.

Barrier #2: over-complicating the documentation

There's no need at this stage to over-engineer any legal documentation. In fact, if you think you need highly specialised legal or accounting advice before choosing your business structure, you're probably complicating things far too much.

Barrier #3: creating a complicated tax optimisation scheme

This is an eye-roller for solicitors and accountants (unless they're the kind who love to take your money, of course). As long as you're not setting up an investment fund or a business that will only work if it's highly tax-optimised, there's no need to even think about using an offshore structure.

The reasons for this are simple. Incorporating a company in a tax haven, such as the Cayman Islands, doesn't in itself mean that the company doesn't have to pay full UK tax. You also have to make sure that it's owned and managed from the

Caymans (generally by the use of a complex trust scheme). That costs a lot of money and is pointless for a start-up that, currently, has no value. What's more, UK investors won't be eligible for tax relief if they invest in your business, which is a huge disincentive for them. You can worry about offshoring your business later, when you have to spare the £50,000 that you'll need.

Barrier #4: getting bogged down in figures

Please don't spend ages creating fiendishly complicated cap tables, with varying predictions of the percentage holdings of shareholders or investors once you've been through five different investment rounds. At this stage you can spend your time more productively elsewhere. Excessive number crunching won't help you with the important tasks of setting up your company and making it a reality in the marketplace.

If any of these barriers are holding you back, you have full permission not to worry about them. Just push them to one side for now.

However, there are some elements of setting up a business that *are* worth thinking about from the beginning. If you don't get them right then they can make your life difficult, deny you future opportunities, and scupper your chances of securing crucial investment. So that you can avoid them, the rest of this chapter will cover:

- the vital differences between for-profit and social enterprise structures, and the impact these can have on your business' viability;

- what it means to create a company, and how to do it without causing future problems for yourself;
- how to pay yourself in a sustainable way; and
- the low-down on taxes and VAT.

For-profit company or social enterprise?

If your aim is to do good in the world, deciding whether your company should be a for-profit business or a social enterprise can be confusing. However, it's important that you understand the differences between the two set-ups if you're not to regret your choice further down the line. So that you can see what I mean, I'm going to explain what social enterprises are first and then move on to for-profit companies.

Social enterprises

Although you may hear the phrase 'social enterprise' bandied about, it's not really a legal term but a label that covers three broad types of business:

- Pure not-for-profit businesses. Here, all the money made is ploughed back into the business to pay its costs and expand its social purpose.
- Businesses that are created to support a social purpose or community, but still return some value to their owners and investors. You can often find these kinds of companies in the education space, for instance, where certain businesses have a core community purpose but still need to attract investment. This is

the kind of scheme that Lucio, our fictional entrepreneur, has in mind.

- Businesses that are primarily for-profit, but with the aim of trading in an ethical way or promoting a social purpose. Today an increasing number of start-ups are created with this aim, because entrepreneurs are often just as motivated by generating social change as they are by making money.

Does your business idea fall into one of these categories? If so, you may be thinking of setting it up as a formal social enterprise, but I'd probably advise you not to. To understand the reasons why, you need to know how these companies are structured and what that means for you. There are many different social enterprise structures, but here are the ones that crop up most often in the UK.

Community Interest Company (CIC)

This is the most common type, and is popular for businesses with a specific community purpose. It's usually set up in a similar way to a for-profit business (in that it has shareholders who own it), but with one crucial difference: it's subject to a statutory asset lock. This stops more than a certain amount of the profits (a maximum of 35 percent) being paid to shareholders.

It's worth thinking about the implications of this by comparing it to a standard for-profit company. In the latter, if you make £100,000 profit you can – in theory – pay out all of it to your shareholders. But with a CIC there's an asset lock, so you can't distribute more than £35,000. Discovering this limitation can be a major 'head in hands' moment for some CIC founders, and they often come to regret using this structure. How are they supposed to generate an income that both they and their shareholders can live on? What's more, once a business is structured via a CIC it's very hard to revert to a for-profit structure.

There is, however, one benefit to CICs, which is that social purpose grants are usually given only to asset-locked businesses. So if you think your funding will mainly come from grant money, a CIC makes absolute sense.

Company limited by guarantee

With guarantee companies, one or more people guarantee the liability of the company up to a certain amount. There are no shareholders or owners, and so no profits can be paid out. The only way to earn any money from such a company is to be a director or employee and be paid a salary. This structure tends to be used for charities and wholly not-for-profit entities.

You can see that a major sticking point with formal social enterprise structures is that there are restrictions on how they return value to their owners and investors. However, there's another disadvantage which is also of huge importance: these structures are not optimised to attract investment. The reason for this is a series of tax incentive schemes available to investors in start-ups. I'll explore them further in Chapter 10, but for now just be aware that the vast majority of UK angel investors use the schemes, and they're only applicable to for-profit businesses. There's an equivalent for social enterprises called social impact tax relief (SITR), but relatively few investors are interested in it. This means that being a formal social enterprise can close investment doors to you.

To me, the choice as to whether to use a formal social enterprise or for-profit structure largely comes down to how you expect to gain most of your funding. If it will be from community or social grants then you'll want to go down the social enterprise route, and if it will be from investors then you'll want the for-profit route. If you're not sure, a for-profit structure is simpler and more flexible (at least in the early stages) because you can run it pretty much how you like and – if it's important to you – still be socially responsible in the way that you do business. Also, while you can switch to being a social enterprise at a later date, *it's harder to do the same the other way around*. If your main aim is to trade ethically or to improve the world in some way, ask yourself whether you can achieve that better via a successful for-profit business.

For-profit businesses

So you've decided to set up a for-profit business. Your most likely structure will be that of a limited company, but it's worth understanding two other structures that are relevant: sole tradership and a Limited Liability Partnership (LLP).

Sole trader

When you set up in business as a sole trader, you're simply trading as yourself. All you need to do is to notify the tax authority, in the UK HMRC, that you're self-employed, and pay taxes on your profits at the end of the year.

However, the downside is that you're personally responsible for any losses that you make. So if your business goes bust, your home and assets are on the line and you can be made bankrupt. Just as importantly, if you have ambitions to build a sizeable business, being a sole trader isn't scalable. You can't raise investment, and it's more complicated to register for value added tax (VAT) and operate as a VAT registered business. We discuss VAT later in this chapter.

Limited Liability Partnership (LLP)

Some people set up LLPs because the owners have limited liability and the structure has certain tax advantages. Instead of the LLP paying tax on its overall profits, as happens with a company, the owners pay income tax on their individual shares of profits each year. However, LLPs are clunky to operate and not easy to scale. Also, investors prefer investing in limited companies because of the tax breaks available to people investing in those kinds of businesses. As a result, LLPs tend to be used only by professionals such as solicitors, accountants, and architects.

Limited company

This is the important one. A limited company is a separate legal 'person', owned by its shareholders. It can enter into contracts, borrow money, employ people, and sell shares in itself to raise money. It can do most of the things that people do, apart from make a mean cup of coffee and come up with cool ideas.

There are a number of advantages to setting up a limited company:

- it's the structure chosen by the UK government for investor tax reliefs, so investors are more inclined to invest in limited companies than they are in any other structure;
- the company has limited liability, so if its business goes bust the personal assets of its shareholders are protected;
- although the company pays tax on its profits (corporation tax), its shareholders don't pay any personal tax until they take money out of it, or sell their shares in it; and
- it's easy to set up and operate – in fact, ridiculously easy. In the UK you can do it yourself online, and there's no minimum sum you have to put in. This is in contrast to some other countries, where you have to invest the equivalent of thousands of pounds just to get a company up and running as well as jump through numerous bureaucratic hoops.

And the downside? It's more expensive to operate than if you're a sole trader. You have to file an annual corporation tax return and accounts with HMRC (which will probably cost you between £750 and £2,000 in accountancy fees), and lodge an annual confirmation statement with Companies House. Having said that, you can see how it's the structure you'd choose if you have aspirations for your start-up to be scalable and attractive to investors.

Setting up your company – what country to choose

If you're planning on incorporating your company in the UK you can skip this, but if you're thinking of basing it abroad there are some important things you need to know. You wouldn't want to deny yourself valuable opportunities, or saddle yourself with huge legal and accountancy costs for no reason.

Your number one consideration is where your investors are likely to be based, because investors usually prefer to buy into companies in the same jurisdiction as their own. This is when you might tell me you're planning on snaring some Silicon Valley cash and will therefore set up your company in the US, but you have to be realistic. If your initial customer base is in the UK or Europe, and if your main networks are also there, it makes little sense for you to set up a company thousands of miles away. Also, a UK company can attract UK investors who'll take advantage of the generous tax breaks from the government when investing in UK firms. If you incorporate abroad, you may be cutting yourself off from these.

So unless you have a really good reason to set up your company abroad, and have a clear plan as to how you're going to make it work, don't do it. Instead, think about where your networks are based, where you'll raise investment, and where your customers are located.

Setting up your company – what to do

Incorporating your business is one of those things that you'd think would be complicated and difficult, but isn't (unless you want it to be). Here's how to make it easy.

Set it up using Companies House

There are many providers who will happily incorporate your business for you for a fee, but you don't need them (or the endless cross-selling spam that you'll be bombarded with afterwards). Companies House is the best option, because it's the government's own system and also links your business into HMRC's corporation tax registration process. This saves you the hassle of working out how to do it for yourself. Just go to www.gov.uk/limited-company-formation/register-your-company.

Use standard articles of association

Articles of association set out the rules of your company, such as how you hold board meetings and appoint directors. When you register your company you'll be offered the choice of using standard articles or creating bespoke ones. The standard ones are fine. Please don't waste your time worrying about how to tweak the articles or getting a solicitor or accountant involved. You can always change them later if you need to, which will probably be when you carry out your first investment round or bring new shareholders on board.

Consider what address to use

You'll need a UK address at which to register your company. This is viewable on a public register, so you may prefer not to use your home. You can ask your solicitor or accountant for an alternative, which they'll often provide for a small fee. Whatever you do, bear in mind that important mail will be sent to this address, especially when your company is first set up. Make sure that whatever forwarding service you use is reliable.

Choose the right share capital

This is the only tricky part, but even so it doesn't have to be complicated. You just have to know what *not* to do.

Your shareholders are the owners of your company, so – at the risk of sounding simplistic – if it's made up of 100 shares and you own 50, you own half the company. When you incorporate, you're asked to pick a type of share. Choose 'ordinary' as these are the ones that allow you to vote, receive dividends (profits), and share in the proceeds when the company is sold. You can change this later if necessary.

You're then asked to pick how many shares you want your company to be made up of, and a nominal value for them. This is when it's easy to come unstuck. The nominal value has little relevance these days but it does represent a sum that you must pay into your company's bank account. Every so often I meet an entrepreneur who's got rather over-excited and decided to set up a company with 1 million shares at a nominal value of £1 each. Woohoo, that's a million-pound company right there! The problem is, as soon as they've clicked 'submit to file', they've committed to paying £1 million into their company's bank account.

If you were to do this, you'd have two problems. The first is that, on the off chance you don't have £1 million to hand, you now owe this sum to the company. You don't have to pay it – you can keep it as a loan – but HMRC will charge you interest on it each year (and on that kind of value, it adds up). Then, if the company were to go bust, the liquidator would ask you to stump up the cash to pay back the company. It sounds crazy, but it's the kind of mistake that takes five seconds to make and many months to undo. You either have to strike off the company and start again, or pay at least £5,000 to a barrister in a wig to go to the High Court and plead your case to reduce the share capital.

What should you do instead? I recommend incorporating with 10,000 shares at a nominal value of 1p each, which totals £100 of share capital. That's a sensible starting point and – as with much else – can be changed in the future if you want to.

Open a company bank account

You need an account in the name of the company, that's separate from your personal one. But who should it be with? Although the high street banks offer more comprehensive services than the challenger banks such as Starling and Tide, they have slow and somewhat archaic procedures for opening company bank accounts. If you want to speed up the process, or if you have foreign co-founders, you might want to go with a challenger. You can always switch to a high street bank later if you want to.

Appoint only one director at first, and make sure they're in the UK

There are two reasons for this. The first is that, when setting up a business account, the high street banks insist on at least one of your company's directors being resident in the UK. The second is that they carry out checks on every single shareholder and director, and require all of them to visit a branch with their IDs. As you can imagine, this is far easier if there's only one person involved. If you don't have any UK directors at all, I suggest opening an account with a challenger bank.

Once your account is opened you can appoint additional directors and issue shares to other shareholders. Most banks won't pick up on this for at least a year, by which time you'll have been able to sort out the necessary documentation. It's a doddle to add shareholders to a company after it's created – you just file a form SH01 with Companies House, and update your shareholder register.

As a side note, never include external investors in your shareholding at incorporation stage. It will void any tax relief they'd have been entitled to (more about this in Chapter 10).

Keep a look-out for your mail

When you set up a company, you find yourself opening a new brown envelope every week. They're mainly from Companies House and HMRC, and no matter how boring they look you should always keep them. The Companies House letter contains your online filing code, which you need for submitting your accounts and other documents online. The

HMRC letter has your company's Unique Taxpayer Reference (UTR), which you need when you register for VAT, file your accounts, and apply for tax reliefs. If you lose it, it can take months to receive a replacement.

You're not quite finished yet

You've set up your company and you've opened your bank account, so what's next to consider? You'll need to decide whether to register for VAT, how to pay yourself, and how to keep financial records.

VAT – to register or not?

VAT is a tax charged on most goods and services in the UK and Europe, at a default rate of 20 percent (there are other rates for certain types of goods and services). Whether to register for VAT is one of the most common start-up dilemmas for entrepreneurs. It may be that you have no choice but to register, as once your annual turnover hits the threshold of £85,000 it's compulsory. However, if you have the option, it's worth bearing in mind the pros and cons of registering early.

The advantage of being VAT registered is that you can re-claim the VAT you've paid in buying goods and services for your business, so that MacBook Pro you bought costs your company 20 percent less. The disadvantage is that you have to add VAT to what you sell, which, if your customers aren't VAT registered businesses who can re-claim it, makes you 20 percent more expensive. If you sell to consumers (in other words, the general public) try to delay registering for

VAT as long as you can, especially if you don't envisage any major VAT-able expenses. If you sell to businesses (who are mostly VAT registered and so can reclaim the VAT), however, it might make sense to register for VAT *before* you hit the threshold, so that you gain the benefit of reclaiming VAT on what you buy.

If you're registering early, my advice would be to ask your accountant to file the application rather than to do it yourself. HMRC is hyper vigilant about VAT fraud, and tends to ask early applicants a bunch of complicated questions which they can find difficult to answer. Far better to have someone who knows what they're doing to handle this than to let it become another barrier to getting your business off the ground.

And while we're on the subject of taxes, bear in mind that you'll be paying corporation tax on your company profits each year. You have to file a return twelve months after the end of your annual accounting period, but pay it nine months after the end of the same period. Bizarre, but true.

Paying yourself

I'm guessing that no matter how passionate you are about your start-up's mission, you'd quite like to earn some money from it. You can pay yourself through a salary as an employee of the company or, if you're a director, in dividends, or both. If you're paying yourself a salary your company will need to be signed up to PAYE, which is HMRC's online tax filing system for employee income tax and National Insurance contributions. Your accountant can sort this out for you.

If you want to be paid in dividends there are two points to consider. The first is that your company can only pay a dividend once it's profitable, which is why many entrepreneurs draw a salary instead at first. The second is that many company owners choose to pay themselves a salary up to the limit of the nil-rate tax band each month, which gives them the NI stamp but also means that they pay no tax. They then draw dividends for the rest of their income. Again, this is an area that's easy to change whenever you want to.

The downside of dividends is that they attract a tax bill at the end of the year. Many founders find themselves in trouble because they don't save enough money to cover their annual tax charge. At first, it might be worth paying a bit more tax on a monthly salary than be hit with a whopping great liability later on.

Keeping records

From day one, please get yourself some accounting software (there are plenty of options that are easy for non-accountants to use) and commit to entering your invoices and receipts on a weekly basis. This will ensure that you have accurate accounting records. Why? First, I've never understood how anyone can run a business without understanding its financial position. How else can you know what your profits are, how much to pay yourself, and what to charge your customers? And second, because you can save yourself a stack of money by presenting your accountant with a neat set of records when it comes to tax and VAT return time.

In the next chapter we'll look at the various risks associated with setting up a business, and how you can reduce them to give yourself the best chance of success.

The wrap-up

- Setting up a company is, for the most part, easy and straightforward. Don't let it be a complication that distracts you from the important work of developing your business.
- There are, however, some pitfalls that you should know about: setting up a social enterprise when you don't need one, basing your company abroad, and choosing the wrong share capital.
- When you're considering your finances, your VAT and tax liabilities are important aspects to take into account.

Lucio

When we last saw Lucio he was sitting in a London cafe, tapping at his keyboard as he mapped out his new business venture. Since then he's made some progress. He's consulted a couple of investors who've told him that, although his aim is to increase social mobility within the recruitment market, they're not prepared to back a social enterprise as they only invest in scalable for-profits. Given that it's going to cost him several hundred thousand pounds to create his online platform, and that there's no way he's going to gain it from grant funding, he's decided to go for a for-profit structure.

Lucio can immediately see that the sole trader route isn't an option even on a temporary basis because he won't be able to raise investment, so he sets up a company called Pre-Train Limited. He also registers it for VAT from the start, because his clients will be businesses. His ambition is to carry out his first major funding round in the US, so he initially plans to incorporate over there. However, after his conversations with investors, he sees that it wouldn't be a good idea as his network and initial target clients are in the UK and Europe.

Finally, he's also gained two co-founders. One is also in the UK (Peter, his CTO for technology development) and the other is in Germany (Sofia, his CMO for marketing and sales). Lucio is the primary shareholder and CEO, and doesn't issue shares to his co-founders just yet because he wants to make sure that he can open a bank account with no problem.

The basics are in place. Lucio has a limited company set up, he's VAT registered, he's opened a bank account, and he has two co-founders to help him drive the business forward. It's looking good, but there are many challenges still to come.

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