Section 3 Start-up

Introduction

Section 3 looks at some of the issues that families setting up in business have to consider, including how to organise the business, how to pay people (including themselves), who will own the business and how to establish good communication between everyone involved in the business. These issues are important at all stages of the business's life, of course, but need to be tackled right from the start.

There are four main issues in this section:

- Topics 1 to 5 look at the different ways in which family businesses organise themselves and the various business structures open to them: sole trader, partnership, limited liability partnership and limited company. This includes a look at the tax implications of each business type.
- Topics 6 and 7 look at remuneration planning: ways of paying yourself and other people out of the profits of the business.
- Topics 8 and 9 look at issues relating to ownership of the business.
- Topics 10 and 11 look at a vital aspect of business: communication, exploring in particular the ways in which families can communicate when working together in business.

Learning outcomes

In this section you will be concentrating on the following learning outcomes:

- explore different business forms and how they are appropriate for different sorts of family business
- describe the various ways in which you can pay yourself, other family members and employees out of the profits of the business
- understand links and relationships between ownership, business and the family
- appreciate the importance of good communication and identify strategies for communicating well
- critically analyse your own situation and devise strategic action plans.

Topic 1: Starting the business

When you have worked through this topic you should be able to:

- describe the various ways in which family businesses come into existence
- summarise the different business forms: sole trader, partnership, limited liability company and limited liability partnership.

Topic 2: Business forms – sole traders and limited companies

When you have worked through this topic you should be able to:

- describe what it means to operate as a sole trader
- summarise the advantages of operating your business as a sole trader
- outline the implications of incorporating the business as a limited company
- describe the obligations on limited companies under the Companies Acts.

Topic 3: Business forms – partnerships

When you have worked through this topic you should be able to:

- summarise the main features of business partnerships
- list the matters that should be included in a partnership agreement
- outline the advantages and disadvantages of family members operating their business as a partnership
- assess whether it is more suitable to operate a business as a partnership or as a company.

Topic 4: Business forms – limited liability partnerships

When you have worked through this topic you should be able to:

- describe the main features of limited liability partnerships (LLP)
- compare these with the corresponding features of general partnerships
- assess which might be more suitable for a family business.

Topic 5: Tax implications of different business forms

When you have worked through this topic you should be able to:

- describe the different forms of personal and corporate taxation
- outline the benefits of incorporation to family businesses
- summarise the use and advantages of share dividends as a means of remuneration.

Topic 6: Remuneration planning – paying yourself

When you have worked through this topic you should be able to:

- describe how methods of remuneration depend on the form your business takes
- understand the need for building up personal wealth separate from the business
- outline the importance of forward-planning, including planning for retirement.

Topic 7: Remuneration planning – paying other people

When you have worked through this topic you should be able to:

- describe different methods for paying people employed by the business
- state the benefits of having a transparent payment scale and a clear, equitable policy for paying family members and non-family members
- identify potential sources of conflict in the area of pay and conditions
- summarise types of employee benefits businesses could consider in addition to salary.

Topic 8: Ownership of the business

When you have worked through this topic you should be able to:

- describe how ownership of the business will depend on the form of the business
- relate size of shareholding to influence and control in the business.

Topic 9: Ownership and limited companies

When you have worked through this topic you should be able to:

- describe different purposes that can be served by widening share ownership in the business
- explore the pros and cons of giving managers outside the family part-ownership in the business
- summarise the main features of different types of share and explain how different types of share can be useful to the family business.

Topic 10: Communication

When you have worked through this topic you should be able to:

- uncover any unspoken rules in the way your family communicates
- assess how well you communicate.

Topic 11: Family meetings

When you have worked through this topic you should be able to:

- outline the value of holding formal family meetings to discuss business matters
- summarise – and follow – the rules for holding effective family meetings.

Section 3 Start-up

Topic 1 Starting the business

All family concerns are created by the initiative of individuals and families keen to devote their energies to running a business. Becoming involved in such an enterprise requires a great deal of commitment and a conscious decision. The circumstances that lead to people taking that decision vary enormously, just as the situations in which family businesses spring to life are very different. In this topic you will investigate the various routes by which individuals set up, or become involved in, a family business.

You will also start your investigation of the different business forms that family concerns may take, such as **sole trader**, **partnership**, **limited liability partnership** or **limited company**. The following four topics continue this investigation.

How do people become involved in family businesses?

There are many routes by which an individual can become involved in a family business:

- starting up a business – either on their own or together with other family members
- taking a position in the family firm – either with or without other work experience
- inheriting the family business
- taking over an existing business (management buy-in)
- taking over a business that they are already working for (management buy-out).

Start-ups

Of all the family businesses currently operating in the UK, the large majority are first-generation start-ups – somewhere between 70 and 80 per cent. This statistic may surprise you – to many people, the term 'family business' conjures up the image of a long-established company, into its second, third or fourth generation, well-known and highly respected within the community. In the UK, however, this is very much the minority situation.

Some businesses are set up with a clear intention of involving several members of the family, with two or more family members going into partnership or setting up a company. Other family concerns arise 'by accident' – or at least by organic growth, where an individual's business becomes successful and attracts or 'sucks in' other family members.

Joining or inheriting the existing family firm

If you work for or run a business set up by other members of your family, you may have grown up in an environment of family enterprise. You may even have grown up with the expectation of becoming involved and possibly inheriting the business.

Management buy-ins and buy-outs

Family businesses can also be created by people seeing an opportunity to take over an existing business, either one they are already managing or a completely separate one. The following paragraphs highlight the difference between these two approaches.

- A **management buy-in** is where someone from outside the company buys it from the current owner(s). The firm may already be a family-run business, and will remain as such, except that it passes from one family to another. Alternatively, the buy-in may turn part of a publicly quoted company into a privately owned family firm, perhaps for the first time in its history.
- A **management buy-out** takes place where a manager already working for a company raises the finance to buy the company from the current owner(s). This often occurs when large companies want to dispose of parts of their business or when the existing owner is looking to retire. The manager will have the advantage of being familiar with the business from the inside and being known to existing owner/managers and other employees. Again, the firm may retain the same status as a family-run business, but change families! Alternatively, it may become a family firm for the first time, in a change to the usual process of industrial concentration.

Choosing the right business form

Whatever the motivation for the business coming into being, one important decision will be to choose the most suitable legal/financial form. Businesses can be organised in several ways:

- **Sole trader** – a business is owned and operated by one person, either with or without employees.
- **Partnership** – two or more people jointly own and run the business, having an agreement between them about matters such as profit-sharing and management roles.
- **Limited liability company** – a separate business entity, which is owned by shareholders or members, but is run by directors (who may or may not be the same as the owners).
- **Limited liability partnership** – only in existence since summer 2001, this form is a cross between a partnership and a limited company, allowing the business to operate as a partnership, but with the protection of limited liability.

Topics 2 to 5 look in more detail at these business forms, and the advantages and disadvantages of them for family businesses.

Check Point

Note down the answers to these questions here and then turn to Action plan 3 in Section 6.

How did your business come into being?

How and why did you become involved in the business?

What is its current business form?

How was that form decided upon?

In what ways is do you think it is the most appropriate form for your business?

Section 3 Start-up

Topic 2 Business forms – sole traders and limited companies

For the smallest family business, the most appropriate legal form may be as sole trader, but at any stage of its existence, the business could be incorporated into a limited company. This topic looks at what these business forms involve and what would make them suitable for different kinds of family business.

Sole trader

This is the simplest business form and is the main form of business for self-employed people. Many family businesses operate on this basis, where the business is effectively run by a single person, who acts as the employer of other family members.

This business form is suitable in situations where one person is clearly in charge of the business – that person makes the important decisions and directs the business as a whole. Other family members contribute to the business, but don't take management decisions and are – hopefully – satisfied with being remunerated by means of wages or a salary, rather than through sharing the profits of the business.

Sole traders have unlimited liability – that is, they are personally liable for any debts that they run up in the name of the business.

Sole traders will need to prepare financial statements for tax purposes, typically a profit and loss account, and balance sheet. However, these are completely private and are not seen by anyone else unless the trader chooses to show them to third parties. A trader might, for example, show his or her financial statements to a bank manager in support of an application for a loan or overdraft, or indeed for a personal mortgage.

Advantages of being a sole trader

The advantages of operating as a sole trader are:

- simplicity – especially when it comes to preparing accounts
- privacy – financial statements do not have to be published
- cheapness – it avoids the expense involved with other business forms, e.g. drawing up partnership agreements, or expenses involved in incorporation and regular auditing (needed by limited companies).

Activity

Look at the five case studies in Section 1, Topic 1. Which of the businesses described could be operated on the basis of a sole trader?

Could they be operated in any other way?

List case studies	Sole trader	Other forms
1 Jane and Keith Walker	◯ Yes ◯ No	
2 Peter Kane and Erik Dahlin	◯ Yes ◯ No	
3 The Patels	◯ Yes ◯ No	
4 James Levine	◯ Yes ◯ No	
5 Jasmine O'Donnell	◯ Yes ◯ No	

Jasmine O'Donnell probably operates her fitness training business as a sole trader although, as you will see, she could also operate it as a limited company.

Armind Patel might operate the newsagent and post office as a sole trader, but on the other hand he may be in partnership with his wife.

Nordic Lines could be run on a sole trader basis, with either Peter or Erik being the sole trader and the other being employed, but it is more likely to be a formally arranged partnership (discussed in Topic 3).

The other two firms have the legal status of limited company and so cannot be sole traders.

Limited companies

One of the options for family businesses – including people already operating as sole traders – is to 'incorporate', i.e. to form a company. This means creating a separate legal entity under which the business operates.

All companies will have **shareholders** and **directors**.

- Shareholders own the company by investing money in shares. In private companies the shares may be owned by a very small number of people. In public companies (those floated on the stock exchange), anyone can own shares and there may be thousands of shareholders. Shareholders do not necessarily participate in management.
- Directors are appointed by shareholders to run the company on their behalf. They may or may not own shares in the company.

In family-run businesses, the roles of director and shareholder are often carried out by the same people: such companies are often referred to as **owner-managed companies**, because the owners (shareholders) and managers (directors) are the same people.

Companies are almost always **limited liability companies**. This means that if the business gets into financial difficulties, creditors of the company can lay claim to the assets of the company but cannot, except in rare circumstances, get at the personal assets of the shareholders. If a sole trader becomes insolvent, there is no such protection, and all the trader's assets, business and personal, may be sold to raise money to pay creditors.

Obligations on limited companies

Limited companies have to comply with the rules of the Companies Acts. They must:

- appoint a company director and a secretary
- hold an annual general meeting
- have their accounts audited by an independent auditor
- report their accounts.

'Reporting accounts' means that a copy of the company's annual financial statements must be lodged with the Registrar of Companies. The Registrar maintains a file for each company, which is open to public inspection, so the financial statements are available to all. There are severe penalties for failing to comply with these obligations, although the detail required from smaller companies is much less now than previously.

All this, combined with the expense of setting up the company in the first place, makes operating as a limited company an expensive option. However, there are possible tax savings to be made and these are examined in detail in Topic 5.

Section 3 Start-up

Topic 3 Business forms – partnerships

This topic continues your look at different business forms by considering what is involved in becoming a partnership. You will consider the advantages of this form to small businesses, as well as some of the pitfalls.

Partnership

The business form of partnership is often used by small businesses owned by two or more people. It is suitable for people forming a business relationship in common with a view to making a profit. A partnership is not a separate corporate entity (in the way that a limited company is), but is a collection of individuals jointly carrying on business. With the exception of certain professions, general partnerships may have only 20 partners.

Partnerships are covered by statutory rules, mainly by the Partnership Act 1890. This Act is far less demanding than the Companies Acts (see previous topic), and so partnerships are generally easier and cheaper to operate than limited companies. For example, partnerships don't have to be registered at Companies House, nor publish their financial statements.

With standard partnerships, as with sole traders, there is unlimited liability.

Partnership agreements

Partners can formalise their relationship by means of a **partnership agreement**. This provides the legal structure within which the partners operate their business. There are obvious benefits to be had from having a written agreement, especially in the event of a disagreement.

Note that a partnership agreement can be either written down or simply a verbal agreement.

Important matters to be covered in the agreement include the following:

- name of firm, the type of business, and duration
- capital to be introduced by partners
- distribution of profits between partners – not necessarily equal shares
- drawings by partners
- arrangements for dissolution, or on the death or retirement of partners
- settling of disputes
- preparation and audit of accounts.

Partners do not usually get a salary for their work in the business (unless there is a specific agreement among the partners to this effect). Instead they share in the profits of the enterprise. The division of profit stated in the partnership agreement may be quite complex in order to reflect the expected differing efforts and contributions of the partners. The partners are taxed individually on their share of the profits.

Interest on capital may be provided to reflect the differing amounts of capital contributed. The percentage profit shares may differ to reflect seniority or greater skills.

Advantages and disadvantages of partnerships

A partnership may be the natural form of business for two family members deciding to set up in business together, e.g. spouses, life-partners or siblings. It may also be a logical progression from a sole trader, if the business expands and the sole proprietor takes in one or more family members as partners (co-proprietors).

Comparing a partnership to sole trading, the **advantages** of operating as a partnership are as follows:

- Business risks are spread among more than one person.
- Individual partners can develop special skills, which the other partners can draw on, rather than being a jack of all trades.
- Certain partners may be able to draw upon larger capital resources to set up or expand the partnership.
- A clear partnership agreement ensures clarity and certainty in various aspects of the business.

The **disadvantages** of partnerships are as follows:

- There may be disputes between partners on matters such as the direction the business is taking or how much money individual partners are taking out of the business. Some partners may feel they are contributing more time and effort to the partnership than others and not being sufficiently rewarded financially as a result.
- Partners are 'jointly and severally liable' for their partners. This means that if one partner is sued in relation to the business of the partnership, the other partners share in the responsibility. Indeed, if one partner has no assets worth being sued for, creditors may turn their attention to other partner(s) and sue them for the *entire* sum outstanding.

A partnership restricts your ability to join together with different individuals to form separate businesses.

Outside investors ('sleeping partners') may prefer to spread their investments, and hence risk, over a number of businesses. This is less easy to achieve and less rewarding with general partnerships.

Partnership or company?

A partnership has some advantages over a limited company, as the arrangement has fewer formal reporting requirements. It may also be easier to dissolve the business. It can be a disadvantage, however, if one partner decides to quit the partnership without notice; this could be disastrous for the business, and the remaining partner doesn't have a guaranteed right to continue the business, unless there is something in the agreement to this effect.

The advantage of a company is that the owners of the business – the shareholders – may be protected from the creditors of the company as regards the payment of outstanding debts.

Activity

Look at the case study of Porters Pianos in Section 1, Topic 6.

Could this business be operated as a partnership?

What would be the advantages and disadvantages of operating the company in this way?

You probably realised that Porters Pianos could be operated as a partnership, although it could also take the form of a limited company. A partnership would be cheaper and have fewer regulations to follow. However, it sounds as if the business could do with a partnership agreement to specify the roles of those involved, especially Charlie and Angela.

Section 3 Start-up

Topic 4 Business forms – limited liability partnerships

The newest form of business entity is the limited liability partnership (LLP). This was created by the Limited Liability Partnerships Act 2000 and has been available for use since 6 April 2001. Here we will examine what an LLP is, its advantages and disadvantages, and whether it would be suitable for your business.

Key features of LLPs

There are key differences between limited liability partnerships and standard partnerships, which make them an attractive option for many small family businesses. The table below shows the key differences and similarities.

Limited Liability Partnership	General partnership
LLP is a legal entity separate from its members.	No separate entity.
An LLP has limited liability.	Partners have unlimited liability.
The LLP can continue in existence independent of changes in membership.	No guaranteed right to continue in business if a partner leaves.
Members (partners) must be registered at Companies House.	No need for registration.
Members can agree matters between themselves by means of an agreement.	Members can agree matters between themselves by means of an agreement.
The partnership is not taxed, but members are taxed on their share of the profits received.	The partnership is not taxed, but members are taxed on their share of the profits received.

These features give LLPs the commercial benefits that come from being a corporate body — particularly the kudos of a limited company and members' limited liability – while giving the partners the flexibility to agree amongst themselves the nature of their relationship. It may also be easier for LLPs to borrow money, e.g. by borrowing against their assets, something general partnerships cannot do.

Separate legal entity

As a separate legal entity, an LLP may enter into contracts and deeds, sue and be sued. This avoids the problems that general partnerships have, where technically it is often necessary for every partner to be party to certain documents or litigation.

Unlike general partnerships, there is no limit on the number of members an LLP may have.

Limited liability

Subject to certain exceptions, members of an LLP have their liability limited to the amount of their capital in the LLP.

The main 'price' paid in return for limited liability is public availability of financial statements. An LLP must file audited accounts annually at Companies House and must also file:

- the name and profit-share of the highest paid member
- the name and address of every member
- details of two 'designated members', responsible for making proper filings at Companies House (and subject to penalties in the event of default).

Tax transparency

A benefit of the LLP status is that it is taxed as a partnership, not as a company — so if you opt for LLP status, you will not have to pay corporation tax. Instead, the members are taxed on their shares of the LLP's profits and gains, just like partners in a general partnership.

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.

Internal flexibility

Members' agreements for LLPs are more complex than general partnership agreements, but are vital, as they have to specify the relationships between the partners, and between partners and the LLP itself. If there is no members' agreement, then the Limited Liability Partnerships Act 2000 will apply certain very basic provisions (for example, that profits should be shared by members equally). However, these provisions are very brief and are likely to be insufficient for any LLP.

The agreement between the members of an LLP remains private and does not have to be filed at Companies House (unlike the Articles of Association of limited companies, which must be filed there).

Uses of LLPs

LLPs were primarily intended for use by the professions, e.g. lawyers and accountants, who traditionally operate as partnerships. However, LLPs may be used by any type of business operating for profit. Since registrations first began in April 2001, a striking feature has been the diversity of businesses using this business form.

Check Point

How appropriate would a limited liability partnership be for your business? Work through the key features summarised here and decide what advantages, if any, would an LLP offer your business. What would be the disadvantage, if any?

Key features	Advantages	Disadvantages
Separate legal entity		
Limitied liability		
Continued existence		
Registered at Companies House		
Members' agreements		
Members' are taxed on share of profits.		

IMPORTANT NOTE: It is always advisable to obtain professional advice when setting up a new business. Since LLPs are so new, it is particularly important in this case.

Section 3 Start-up

Topic 5 Tax implications of different business forms

By now you should be gaining a clear idea of the benefits and drawbacks of different business forms. You may already have reached some conclusions about whether your business's current form is the most appropriate one. There is one important element to this that you will need to throw into the melting pot: **taxation**. For many people, this is the decisive factor about what form their family business should take.

Personal tax vs corporate tax

Everybody has to pay taxes – and by everybody, we don't just mean people. Companies too are regarded as 'bodies' for the purposes of taxation, and so have their own form of taxation: corporation tax.

In this world nothing can be said to be certain, except death and taxes.
Benjamin Franklin

The main tax implication of different business forms, therefore, is whether you pay tax as an individual at personal tax rates (through income tax and national insurance) or *through your business* (through corporation tax). The rates of tax are different and, depending on your circumstances and the size of your business, there are substantial savings to be made by choosing one form over another.

- Sole traders, partners in partnerships and members of limited liability partnerships are taxed as individuals on the profits arising in the business as they arise. There are various bands of income tax, with (at the time of writing) a narrow 10% for low earners, a standard rate of 22% and highest rate of tax set at 40%. Individuals also have to pay national insurance.

- A limited company is also taxed on its profits arising – at corporation tax rates, which for most family businesses would be 19%.

The benefits of incorporation?

The lower rates of tax for companies are an incentive for many businesses to consider incorporation (i.e. setting up as a company). In his Spring Budget of 2002, the Labour Chancellor Gordon Brown made two significant reductions in corporation tax:
- a reduction from 10% to 0% on profits up to £10,000
- the small companies' rate reduced from 20% to 19%.

Corporation tax profits 2002–03

Starting rate zero	£0 – £10,000
Marginal relief	£10,001 – £50,000
Small companies' rate 19%	£50,001 – £300,000
Marginal relief	£300,001 – £1,500,000
Main rate 30%	£1,500,001 or more

Many observers have identified a trend for small, incorporated companies to be treated more kindly than sole traders and the self-employed. This was not the current Chancellor's first reduction in corporation tax: back in 1997, when Labour came to power, he cut the small companies' tax rate, and again in 1998. Brown, described these measures as helping companies up the ladder 'from employment to self-employment, from micro business to growing business'.

For small businesses making very small profits (less than £10,000), this offers the chance for some substantial savings:

… Pricewaterhouse Coopers calculates that a self-employed person would typically pay £1,435 this year in standard-rate tax and national insurance on trading profits of £10,000; if the business was incorporated and the profits distributed through a dividend, the potential tax bill would fall to zero.'
Andrew Bibby 'Budget benefits for small business', The *Observer*, Sunday 28 April 2002

Dividends or salary?

The key to saving is the flexibility in payment methods offered to limited companies. An owner/manger can be paid either as a shareholder (through dividends) or as a director (through a salary). Salary and dividends are taxed in totally different ways and so give the individual the chance to minimise the tax on profits extracted from the business. Paying a dividend instead of a salary also avoids the need to pay national insurance.

There are two ways of taking advantage of the potential savings from this flexibility:

1. incorporate the whole business, i.e. set up a limited company
2. introduce a company to a partnership – as a separate legal entity, a company can be a partner, just as easily as a human being can. The company is then taxed at corporation tax rates on its share of the partnership profits.

Having said all that, there are complications and potential pitfalls with using dividends as a vehicle of payment:

- Dividends are treated differently for employers and employees.
- Dividends, when declared, are given for a class of shares and so all shareholders would be entitled to the same rate, including non-working shareholders, if any.
- Dividends should not be declared on a monthly basis or else they may be recategorised for national insurance.

A final consideration is that, while it's easy to become an incorporated company, it's not so easy to become unincorporated later because there are tax implications in doing this.

As you have probably gathered, taxation is a very complicated area and if you are contemplating changing the status of your business, you need to weigh up your options very carefully. The most important thing is to get professional advice.

Check Point

Topics 1 to 5 in this section have looked at the different forms of business structure. In the check point at the end of Topic 1 you thought about your business's current form. Having worked through these five topics, what are your current thoughts about the most suitable form for your business?

In the space below, note down which business forms might be suitable for your business. Summarise the advantages and disadvantages to your business.

Business form	Advantages	Disadvantages

Section 3 Start-up

Topic 6 Remuneration planning – paying yourself

Topic 5, on taxation, raised some issues about methods of remuneration – i.e. paying yourself out of the profits of your business. This topic follows on naturally and looks not only at how you pay yourself, but at some of the key issues involved.

Methods of paying yourself

As you will have gathered from Topic 5, the way in which you pay yourself depends on the structure your business takes.

- Sole traders receive the profits of their business as an income.
- Partners in partnerships (and members in LLPs) receive profits of the partnerships in divisions agreed between the partners/members.
- Directors of companies receive an income as an employee of the business.
- Shareholders of companies receive income in the form of dividends.

Topic 5 discussed the tax implications of these methods of paying yourself.

However payment is made, the key issue is to ensure that there is a proper system in place for payment and that owners/managers regard this payment as personal wealth, not part of the family business wealth. The point of this is to encourage individuals to build up assets outside the business. With many family businesses, there is a temptation to plough everything back into the business, e.g. by taking the absolute minimum as personal income and leaving as much as possible within the business.

Activity

What are the dangers of extracting the minimum income from the business and not building up personal wealth?

"I'm so busy keeping the business running that I don't have time to spend a large amount of money, so why worry about how much I am paid?"

What do you think of this attitude?

The obvious danger in not building up any personal wealth (as opposed to business wealth) is that it leaves no leeway or fall-back position if the business has difficulties. In the unpalatable situation where the business folds, the owner-manager is left with nothing to show for years of labour. In the worst situations, where owners have invested personal resources into the business, e.g. given the bank a charge on their property in order to prop up the business, they may be left literally without a roof over their heads.

Conversely, if the business prospers, there is the political risk that wealth extraction may be more difficult and/or costly under a future government than at present.

It is also a good discipline to separate out personal life from business life – easier said than done with many family businesses, but important nonetheless.

I have heard the argument from fellow family-business owners that it's more important for the business to prosper than for them to take regular, decent salaries. And so they scrape by month after month, working long hours and paying themselves a pittance. My view is that if the business can't sustain you and your family in a decent standard of living, then you might as well pack up now, and go and get a 'proper job'.

Sam, owner of a family business

Forward-planning

Remuneration should be seen as part of a long-term strategy, which includes planning ahead to the retirement of the current owner. For the owner, that should include pension planning. Again, payments in pension plans may be one of the lowest priorities, especially if things are tight financially for the business, but they may be an essential part of a pension-planning strategy, especially given the gradual erosion in value of state pensions.

Without pension provision, the situation will arise when the owner is faced with difficult options at retirement: one may be having to postpone retirement and carry on working.

If the owner's assets are all tied up in the business, then the owner has to find a way of extracting them without harming the business. This can prove problematic, for example if there is no obvious successor or if the natural/chosen successor cannot raise the necessary finance to take over the business. For this reason, planning for retirement cannot be started too early (this topic is covered in more detail in Section 5, Topic 14).

It's also worth remembering that payments into pension schemes are one of the most tax-efficient ways of saving.

When you're 35 and working 14-hour days to get the business going and keep it up and running, planning for your retirement is the last thing on your mind. Thank God I had a good Financial Adviser who forced me to start investing money outside the business – in pension schemes and unit trusts mainly.

Philip

Check Point

Think about the following questions before completing Action plan 3 in Section 6.

1 How do you currently pay yourself out of the profits of the business?

2 Is this the most effective way of paying yourself?

3 In what ways are you building up personal wealth separate from the family business?

4 How far advanced are your plans for retirement?

Section 3 Start-up

Topic 7 Remuneration planning – paying other people

In the last topic you looked at some of the issues involved with paying yourself as the owner/manager of your family business. That topic stressed the importance of careful, long-term planning. In this topic you will explore issues to do with paying other people who work for the family business – whether they are family members or not.

Paying family and non-family members

Remuneration planning should also include policies and guidelines for paying employees of the business. Employees can include both family members and non-family members. In family businesses, the existence of family relationships in the workplace can raise particular issues, especially where the highly sensitive question of money is concerned.

Some of the questions to consider are given in the following checklist.

Checklist for remunerating employees

- How will family members be paid – by means of salary or by sharing in ownership benefits (e.g. shares)
- How will non-family members be paid?
- What benefits, apart from salary, will you pay employees?
- Will these benefits be available to all employees?
- Will there be a distinction between how family members and non-family members are paid?
- How transparent will the business's payment scale/policy be?
- Will it cause friction if family members are perceived as being treated better than non-family members?

Sources of conflict

There is always the potential for conflict whenever people perceive inequality in their pay and conditions. And it isn't always a battle between family members and non-family members; family members too can fall out. For example, siblings are acutely aware of any hint of unfairness – they may even perceive it when it doesn't exist.

In business, pay should be based on contribution, not DNA.
Charlotte Lucas, MD, James Levine Ltd

Activity

Read through the following case study. What mistakes is Kevin making and what should he be doing instead?

Kevin Dalton is the owner manager of a car auction business. Both his children work in the business, but he hands out money 'as and when' to siblings, on the basis that business income is not regular and it is up to him to decide how much to give out and to whom. His decisions are often based on his children's personal circumstances, so that Dave, his married son, is consistently given more than Sharon, his unmarried daughter. He also often slips Dave an extra couple of hundred in cash. When challenged by Sharon about the unfairness of the situation, Kevin told her that Dave needed more money – and besides Dave had children to provide for and they were 'the future of the business'.

You will have spotted a number of things that Kevin is doing wrong.

He is causing friction between his children by paying them unequal amounts. In the long run this could hurt his business if it creates tension in the family.

He should have a much more formal system for making regular salary payments to his children.

By paying Dave in cash, he is trying to avoid his tax and national insurance obligations – this could well backfire on him and the business.

Employee benefits

All employees receive their main income in the form of wages or salary. Businesses have also used various other ways of rewarding staff. These include:

- contributions to pension schemes
- medical insurance cover
- company car
- interest free loans
- relocation expenses
- workplace nurseries
- subsidised canteen facilities
- share schemes.

Many of these do have advantages, especially in the area of tax efficiency. Medical insurance cover, for example, saves employee's NI contributions (although employers still have to pay).

Share schemes

Another way of paying employees, only relevant to businesses operating as limited companies, is by means of share schemes, which also often have the benefit of being tax efficient. Recent governments have encouraged this type of scheme, not least as a way of involving employees in the success of the business they work for.

Schemes include:

- All employee share ownership plan (AESOP)
- Enterprise management initiative (EMI).

These have their uses, but many family firms are wary of extending share ownership beyond the immediate family (see Topic 8). However, this kind of scheme can be a useful way of involving managers (family or non-family) more closely in the business, especially if the owner is considering retirement or even selling the business.

Check Point

How do you currently pay your employees out of the profits of the business?

Work through the checklist opposite and note down any points that arise from it. In particular, note down:

- any differences in the way family members and non-family members are paid

- what benefits you make, or could make, available to employees

- whether pay and conditions have been the source of any discontent within the business, and if so, what action you might consider taking in this area.

Now turn to Action plan 3, and note any action you need to take.

Section 3 Start-up

Topic 8 Ownership of the business

When a business is set up by whatever route (e.g. as a new concern, through a management buy-in or buy-out), the question arises of who will own the business. In some family businesses, this will be obvious: the business may be the initiative of one person who will own and run it. Similarly, a couple going into the business as equal partners may share ownership in the same way as they share profits.

In other situations, however, ownership will not be so clear-cut. Who will be the owner if two partners go into business together, but one person puts up all the capital? What about a spouse who contributes capital but doesn't want to take part in the actual running of the business?

This topic looks at questions of ownership and how, especially in limited companies, it is possible to be both flexible and creative in questions of ownership.

Who owns the business?

How ownership is agreed will depend upon the form of business.

- Sole trader = by definition, trader is single owner of business (business is not separate from person).
- Partnership/LLP = ownership will normally be indicated by how profits are divided, and this division should be stated in the partnership or membership agreement.
- Limited company = ownership is established by division of shares.

For sole traders and partners in a general partnership, ownership is tied up inextricably with the individuals running or contributing to the business. If an individual withdraws from the business, there is nothing to own – the business stops, or the partnership may need to be dissolved.

With limited companies', the situation is rather different, as there is a separate corporate body involved which can be 'owned'. The rest of this topic and the following one refer specifically to limited companies and the ways in which they can be owned.

Shareholding, influence and control

In limited companies, ownership is expressed by the holding of shares in the company. The size of the shareholding determines the amount of control and influence in the company, as described in the following table.

Shareholding	Control and influence
0–9%	Only minority rights to avoid oppression from the majority.
10–25%	Consent required before an offer for the company can be declared unconditional.
26-49%	Can block a special or extraordinary resolution to sell, wind up, or change the Articles of Association.
50%	Can block an ordinary resolution regarding normal business requirements, such as the appointment of directors. Could control the company with the assistance of one other shareholder or in the absence of minority shareholders exercising their rights.
51%	Controls the company.
75%	Can pass a special or extraordinary resolution.
90%	Can accept an offer for shares in the company which will bind the other minority shareholders.
100%	Absolute control.

Source: Stoy Centre for Family Business (2000)

Activity

Read through the following case study. Suggest an appropriate division of shares that would keep all members of the family happy – or at least relatively happy…

The Bonnetti family is about to set up a business finding and arranging accommodation for asylum seekers who have made their way to the UK. They will work directly with the Home Office who will pay them a fee for each person they make arrangements for. Paola will be Managing Director of the company; her sister Riccarda will be Company Secretary and will be in charge of the administrative side of things. Paola's two children, Lydia and Pietro, will do most of the face-to-face liaising with the hotels, B&Bs and other places offering accommodation. Each of the four people will be a director. Paola wants to have control of the company, as senior member of the family and the one whose business idea it was, but none of the others are especially happy with this, especially Paola's children, who feel that if Paola was in complete control, they would 'just be dogsbodies'.

You might have thought that an appropriate division of shares would be for Paola to have a 40% holding, and each of the others a 20% holding. This would mean that Paola would always need the agreement of at least one of the others if she wanted to exercise control. At the same time, the other three could join together to overrule Paola if they felt she was being too domineering. Paola would need the agreement of two of the others in order to pass a special or extraordinary resolution.

In this example, share ownership is used to express the amount of control in the business, rather than ownership of the company's assets (as there are no real assets). In the next topic, you will look at other purposes that ownership of shares may serve.

Section 3 Start-up

Topic 9 Ownership and limited companies

In Topic 8 you looked at how ownership in limited companies is expressed through shareholding and how this can be used to reflect levels of control and influence within the business. In this topic, you will look at other purposes that ownership of shares may serve. You will also see how different types of share can be used to serve different purposes in family-run businesses.

The purpose of ownership

It is important to make clear decisions about the ownership of the business, especially if it is in the form of a limited company. In the early stages of the business, this may seem to be a fairly uncomplicated decision, but if the number of people involved in the business increases, the decision becomes more complex. Understanding the purposes – and possible future uses of – share ownership can help owners/managers to make good decisions early on.

Checklist: purposes of ownership

How is ownership of shares used in the business? Is it used:

- to reflect levels of control and influence within the business?
- to reflect investment made in the business?
- to reward effort and achievement within the business?
- to foster a feeling of family involvement in the business – to strengthen the feeling that the business is the whole family's concern, even though few members may be actively involved?
- as an incentive, especially to non-family members joining the firm?
- as a means of providing remuneration instead of or in addition to salary (e.g. through dividends)?

If a business survives into the second or third generation, ownership may inevitably become spread across a wider range of people, for example when a family member bequeaths their shares to several children or relatives.

Non-family involvement

As mentioned above, share ownership can be used to provide an incentive to non-family members who are brought into the firm as managers. Giving them a share in the business is also a sign of your commitment to them, especially if the manager is the only non-family member in the firm and may have concerns about this.

Not all families are willing to let outsiders have a share of ownership. A survey conducted by the Family Enterprise Centre of Bournemouth University found that the majority of family businesses specifically restricted ownership of shares, usually in the company's Articles of Association.

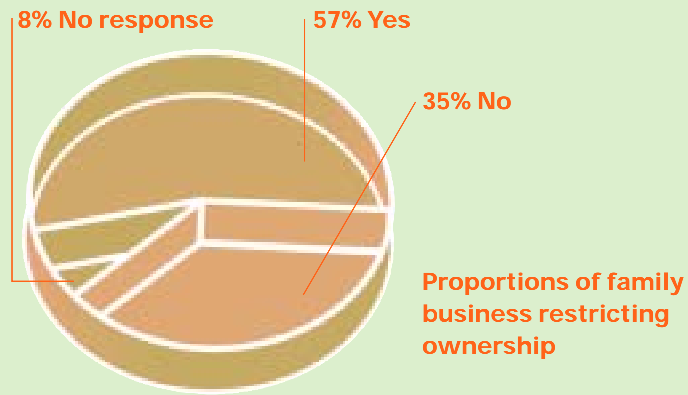
Types of shares in limited companies

A company may have as many different types of shares as it wishes, all with different conditions attached to them. For example, some carry voting rights, while others do not. This can be particularly useful for family-run businesses, as the distinction can be used to separate ownership from management. For example, non-executive family members can hold non-voting shares so that they retain an interest, while the business decisions are taken by executive members holding voting shares.

Different types of shares are also useful for owners who want to pass on an interest in the business to their children, e.g. where one child is active in the business but the other is not.

Generally share types are divided into the following two main categories:

- **Ordinary** – are the normal shares of the company with no special rights or restrictions; may be divided into classes of different value.
- **Preference** – normally carry a right that any annual dividends available for distribution will be paid preferentially on these shares before other classes.



Proportions of family business restricting ownership

A company may alter the rights attached to any class of shares. How this can be done depends on whether the rights stem from the Memorandum or Articles or elsewhere.

Aspect	Ordinary shares	Preference shares
Voting power	Carry a vote.	Do not usually carry a vote.
Distribution of profits (dividends)	A dividend, which may vary from one year to the next, after the preference share-holders have received their dividend.	A fixed dividend (fixed percentage of nominal value) in priority to ordinary dividend.
Liquidation of the company	Entitled to surplus assets on liquidation, after liabilities and preference shares have been repaid.	Priority of repayment over ordinary shares but not usually entitled to share in surplus assets on liquidation.

Where the business has developed into a larger concern, with a number of shareholders, it is vital to put into place a policy for transferring, acquiring and disposing of shares. This is equally important if you reach a point where you are contemplating widening the range of shareholders.

Check Point

Who owns your business? What form does this ownership take?

If your business is a limited company, describe:

- the number and types of shares that make up the company's share capital
- what rights accrue to each class of share
- who owns the shares
- how ownership of shares is used for different purposes within your company
- what might happen in the future with regard to share ownership.

Summarise the key points arising from your work on the last two topics Action plan 3 in Section 6.

Section 3 Start-up

Topic 10 Communication

All businesses stand or fall by the way they communicate. Family businesses are no different in that respect. What is different is the extra layer of complication that can be created by the fact that business managers are also family members.

Where a husband-and-wife team run the business, they can have 'board meetings' in bed, in the shower or over a pizza watching TV … That may work well for them, giving them a chance to talk over things away from the immediate pressure of everyday business tasks. But, when there are other managers involved, this way of working can be threatening. There have to be formal ways of communicating.

Communication skills: good practice

This book doesn't aim to provide a crash course in communication skills – there are plenty of dedicated books, learning packs and courses on those, most of which cover the topics listed below. In this topic and the next, you will focus on aspects of communication that arise when family members communicate in business. Areas to think about include:

- choosing appropriate methods of communicating – following proper business procedures, even when it may seem unnecessary because you can 'have a chat at home'
- listening skills – giving your ear equally to all members of the family, and to both family and non-family members alike
- speaking skills – using the correct level of formality in formal situations, even when talking to your partner, parent or sibling
- body language – using body language appropriate to the situation, e.g. is it appropriate to go up to the finance director in a production meeting and give him/her a kiss?

How the family communicates – unspoken rules?

Many family business managers assume that because the business involves family members, communication is bound to be open and easy. This is often far from being the case. In fact the opposite may be true: families have years or decades of history that affect the way they talk to each other.

There are often unspoken rules that may hinder communication, for example:

- 'No one contradicts dad. When it comes down to it, his word is law.'
- 'Whatever position Peter supports, Helen will take the opposite view – that's just the way it is. You have to let them have their ritual argument before the discussion can move on.'
- 'Ben will never express his views in a meeting, as he hates disagreeing with anyone. He'll tell you privately what he thinks.'
- 'If you want to suggest an idea to Sharmi, you can do it face to face, but it's often better to suggest it to Anita – if she likes the idea, you can be sure it'll get a good press with Sharmi.'

These unspoken rules may conceal hidden agendas – perhaps the result of disagreements or resentments going back years. What is it, for example, that made Peter and Helen fall out? Was it a battle over business strategy or the fact that Helen's husband was rude to Peter on a camping holiday in the Lake District seven years ago …?

Activity

What are the unspoken rules of communication in your family?

How do they hinder communication?

How do they affect the way the business works?

What would happen if someone were to challenge them, e.g. decide to contradict dad, or tell Helen and Peter that their constant arguing is damaging the business, or encourage Ben to speak openly in meetings?

Challenging these 'unspoken rules' is hard because it means bringing suppressed tensions to the surface. The temptation is to take the easy course and keep following the rules, even though conflicts can be resolved if people are willing to approach them fairly. However, honesty is paramount and the business is more likely to survive and prosper if there are no secrets.

How you communicate

To end this topic, think about how you communicate. To do this, look back at the list of skills opposite, to remind yourself of the basics of good communications. Then go through the questions in the Checkpoint, before completing the Action plan in Section 6.

Check Point

Think about your own style of communicating.

- How well do you listen to others?
- Do you listen equally to all members of the family, or do you give more time and attention to particular individuals?
- Do you listen to family and non-family members alike?
- Do other people know what you think?
- How do you communicate your views and decisions to:
  – family members?
  – non-family members?
- Do you treat all managers alike?

Summarise your answers to these questions in Action plan 3.

Section 3 Start-up

Topic 11 Family meetings

This topic continues with the theme of communication started in Topic 10. Having identified some of the communication problems that can occur in family-run businesses, you will move on to look at some principles of good communication in family firms, and in particular the role and value of 'family meetings'.

Keeping it in the family

When families run businesses, communication happens not only in the business context, but also in the family setting, i.e. the home. These more 'informal' channels can be effective, but can create difficulties too, such as:

- decisions are made between close family members, without consulting other family members
- non-family members may feel excluded from decision-making
- when decisions are made, they may not be communicated formally to all those who need to know.

For these reasons, it is important to have family meetings that take a business-like approach.

Family meetings

Family meetings provide an opportunity for family members to sit down and discuss business matters in a proper, formal atmosphere. These meetings should not be the same as an informal chat over the dinner table. By setting them up and treating them as any other business meeting, you can reduce the syndrome whereby family dynamics and hidden agendas interfere with decision making, rather than promote it.

My husband and I have run our flower business together for 12 years. When it's busy – e.g. when we have some big weddings on, we hardly get a chance to talk about business things. We used to talk about those at home – or rather I'd talk and he'd grunt. I felt he was only half-listening and would have to raise the same subject again another time to check what he thought. I got sick of that and insisted we timetable in a proper time to talk over business things. We now meet every Monday afternoon in the back room of the shop. Kerry, our assistant manager, makes sure we are not disturbed and since we're both paying full attention, we rattle through things.
Sheila Norman, Norman's Flowers Ltd

Activity

What sort of meetings does your family have to discuss business matters?

Are they adequate or suitable?

Can you, at this stage, suggest any improvements that could be made?

Communication among family members is key, but I found that with ten or so relatives active in the business as managers or shareholders, there were real communications problems – business plans, strategies and decisions would be communicated down different channels, changing shape en route. Talk about Chinese whispers! So we instituted bi-monthly meetings for family members, as well as a yearly gathering for every family stockholder over age 16, called the 'annual family gathering'. The meetings began eight years ago at the suggestion of a consultant.
Keith O'Brien, Chairman and Managing Director of O'Brien Engineering

As the Normans found, by formalising the business communications, the non-business relationships can be strengthened. For example, by putting in the Monday meetings, not only is the need to address business questions met, but both spouses will feel more relaxed and less stressed at home.

Family constitutions

Family meetings, and arrangements for holding them, may be one of the areas covered in a 'family constitution' – a document agreed by the family to clarify responsibilities of family members towards each other and the business. This subject is covered in Section 4, Topic 3.

Check Point

Below is a checklist for holding and running family meetings – and, most importantly, for communicating well during the meeting. Work through the checklist before turning to the last part of Action plan 3. There you can list opportunities for your family to make changes for the better.

Checklist: Rules for family meetings

	We always do this	We sometimes do this	We never do this
Meeting rules			
• Treat the meeting as you would any other business meeting.	○	○	○
• Agree a date, time and venue.	○	○	○
• Stick to the agreed time – don't treat the meeting as dispensable.	○	○	○
• Produce and distribute an agenda, as you would for any other meeting.	○	○	○
Listening			
• Listen equally to everyone.	○	○	○
• Make sure everyone has a voice.	○	○	○
• Be willing to understand each other's viewpoints, even if you disagree with them.	○	○	○
• Show respect at all times. Don't use your intimate knowledge of someone to undermine them.	○	○	○
• Do not interrupt, even if you disagree.	○	○	○
Speaking			
• Say what you mean, but be sensitive – don't disguise rudeness as honesty.	○	○	○
• Above all, don't make personal attacks.	○	○	○
• Use logic not emotion.	○	○	○
• Be precise – don't be vague.	○	○	○
• Do not dwell on past issues, especially ones unrelated to the business.	○	○	○
• Do not cloud business issues by bringing in personal family issues.	○	○	○
Reaching agreement			
• Focus on core objectives and philosophies, rather than personalities.	○	○	○
• Don't lay down the law: search for consensus.	○	○	○
• Never agree to anything you have reservations about without first voicing your concerns. Encourage others to do the same.	○	○	○
• Use professional advisers if necessary to help discuss family members' objectives and different needs.	○	○	○
• Never be afraid to take advice and share problems.	○	○	○