

SOLE TRADER vs LIMITED COMPANY

“The question we probably get asked most often by small business owners is whether they are better off as a limited company or as a sole trader.

In truth, there are pros and cons to both options and the answer will depend on your business and personal circumstances. There are a number of important tax and legal differences between operating as a sole trader and through a limited company.

In many cases there can be a real benefit to creating a limited company – both from a legal risk perspective, as well as from a financial and tax efficiency perspective.

In this article, we provide some of the key factors to consider if you are considering moving to a limited company.”

Catherine Bond
Director, Blue Peak

WHAT ARE THE KEY POINTS TO CONSIDER?

At high level and from a purely financial view, operating a limited company usually brings some tax advantages, however it usually brings with it increased compliance costs (both in terms of time and money). Anyone considering switching therefore needs to understand whether the tax savings from being a limited company will outweigh the increased costs involved. Running a limited company also legally separates the owner from the business and therefore usually reduces the personal financial risk you are taking on by running your business.

WHAT ARE THE TAX DIFFERENCES BETWEEN BEING A SOLE TRADER VS A LIMITED COMPANY?

As a sole trader, the profit you make from your business is taxed as employment income. This means that you will pay income tax (in 2018/19: basic rate: 20%, higher rate: 40% or additional rate: 45%), as well as National Insurance contributions (Class 2 @ £2.80 per week and Class 4 @ 9% below the earnings threshold and 2% above the earning threshold).

For limited companies, corporation tax is paid on your profit (currently 19%, reducing to 18% from April 2020). To pay yourself from the company it is normal to then use a mixture of wages (which are taxed as employment income) and dividends, which currently attract lower tax rates than employment income.

In short, the specific rates of tax you will need to pay under the two options will vary depending on the tax bands your income falls into, and your personal financial circumstances, however, as a guide the combination of corporation tax and dividend income from the limited company option is usually lower than the tax you pay when self-employed for annual profits from the business up to £144K.



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WHAT OTHER THINGS SHOULD I CONSIDER?

Running a limited company brings with it an increased compliance overhead as there are several legal duties you must comply with when running a limited company.

These include:

You are required to file accounts to company's house once a year. These are more complicated to prepare than sole trader accounts and usually require professional help.

You are required to appoint at least one director who will have to comply with the director's statutory responsibilities.

You will need to fill in a corporation tax return for the business, you will also have to fill in a personal self-assessment return to account for any income you receive from the business when it is first legally set up which may affect trading relationships.

The business is legally separate from yourself as an individual. This can be an advantage as this usually limits the owners risk from the venture if the business gets into financial difficulties, however it can also be a disadvantage (for example the business may have no credit rating).

WHAT NEXT?

Although there are clearly some beneficial tax advantages to creating a limited company, whether it's right for you will depend on your circumstances and would need to be balanced against any additional reporting obligations that your business may have as a company. This is a complex area so we would always recommend getting professional advice to consider both the financial and legal aspects before making any changes to your business setup.

If you are interested in understanding further how a limited company might benefit you, and for more information on the differences between the two just get in touch.

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