Limited Company vs Sole Trader

If you're starting out in business a big decision to make is whether to trade as a sole trader or a Limited company. There are many factors you should consider before you decide. Let's look at the advantages and disadvantages of trading through a limited company.

The big change: you and your company are no longer the same thing

When you're a sole trader, you and your business are legally one and the same. But if you turn your business into a limited company (this is also known as 'incorporation'), the company becomes a separate legal entity from you. This legal separation can work as both an advantage and disadvantage of incorporation, as you'll see.

Advantages of incorporation

Switching from sole trader to limited company could save you tax

There are indeed some tax savings to be made by making the switch from sole trader to limited company. Limited companies don't have to make Income Tax payments on account, for example, but sole traders do. And while sole traders pay 20-45% Income Tax on profits and class 4 National Insurance, limited companies pay Corporation Tax on profits at only 20% (until its profits exceed £300,000 a year), and no National Insurance. However, it's important to bear in mind that limited companies are not entitled to a personal allowance, so these tax savings would only be beneficial once your profit starts to exceed around £50,000.

It's important to discuss any potential tax savings carefully with your accountant, and to ask them to calculate what you could save. This will depend on your business's circumstances, and, in particular, whether you have any other sources of income.

You could claim more tax relief on certain costs

When you run your business through a limited company, some costs are given more tax relief than they are for sole traders. For example, a limited company can pay for food and drink for employees (including you!) whenever they're out and about on business.

Sole traders, on the other hand, can only claim tax relief on these costs in certain circumstances (e.g. when the business trip involves an overnight stay).

Limited companies can attract investment more easily

If you are looking for investment in your business, incorporation could be an advantage for you. As a limited company, you will be able to sell shares in your business to an investor relatively easily. Sole traders, on the other hand, cannot seek investment, unless they go through the complex process of turning their business into a partnership.

You would have limited liability protection

Because a limited company is a separate legal entity from its directors, the company can own equipment, incur debts, and pay bills in its own right. That means that if the company is sued, your own personal assets, such as your house and car, cannot be seized to pay the debt, unless you have given a personal guarantee to a company creditor. If you are a sole trader, on the other hand, your own assets could be seized to pay a business debt, because you and the business are legally the same entity.

Disadvantages of incorporation

Running a limited company means more paperwork

Sole traders only have one document to file with government bodies each year: their tax return. However, a limited company has to file:

- a set of accounts
- an annual return
- a corporation tax return

In addition, each director has to file a personal tax return to HMRC. If you are an employee of your company and take a salary, you will also have to register the company as an employer and set up a payroll.

All this means that after incorporation you will either have to spend more time preparing and filing paperwork, or you will need to pay your accountant more to do this for you.

Becoming a limited company involves potential tax costs

As the director of a limited company, you would no longer be able to draw money freely out of your business bank account. The company could pay you a salary, pay dividends

on the shares you own, and reimburse you for any expenses you incur on its behalf. However, if you were to take money out of the company for any other reason, you may have to pay extra tax.

Another potential tax implication is that when a limited company makes a loss, it can only use that loss against its own profits. Sole traders, on the other hand, may be able to use any loss their business makes to save tax on their other income. So if a sole trader is also employed elsewhere, for example, they may be able to use their business losses to reduce the tax they pay on their employment income.

As the director of a limited company, you will have legal duties to fulfil

Your legal responsibilities as company director would include safeguarding the company's assets, and making the decision to cease trading if you knew the company couldn't survive. If you fail in your legal responsibilities as a director, the consequences can be serious: you could be fined or even go to prison.

Limited companies have less privacy than sole traders

When you file your company's accounts and Confirmation Statement, these documents will be in the public domain, available for anyone to see on sites such as duedil.com. This means that your figures will be visible to the public, along with your company's office address (although you could make this your accountant's office, rather than your own home).

Weighing up the pros and cons

As you can see, there is no simple answer to the question and one size definitely does not fit all. But when starting out, you need to keep costs to a minimum so there is a case to be made for being a sole trader initially – you can always convert to a limited company later. The main reason against this approach would be if you are operating in a business that could be classed as being a risk to customers, the public or employees. In this case, incorporation would mean that if a catastrophic accident occurred and damages were awarded more than your liability insurance, the excess would fall on the company and not on you. The other reason to incorporate from the outset is if friends and family want to invest in your business where they would obviously want to have shares.