Self Employed or Limited Company (2017/18 Tax Year)

Making the decision as to which structure your business operates as can be crucial, whether that be in terms of tax savings, perception to the outside world, keeping things simple or future plans you may have.

Sole Trader Tax As a sole trader an individual must pay tax on all profits over and above their personal allowance, for most tax payers the personal allowance is £11,500 for the 2017/18 tax year.

Once the personal allowance has been breached tax is paid at the rate of 20% in the basic rate of tax (up to £45,000 income), 40% as a higher rate taxpayer (over £45,000) and 45% in the additional rate band (over £150,000 income). There are also further personal tax issues to consider such as child benefit starts to be withdrawn once your income goes over £50,000 and the personal allowance begins to be withdrawn once your income is over £100,000.

As well as tax, for a sole trader there will be two forms of national insurance to consider, Class 2 and Class 4.

Limited Company Tax A limited company, pays corporation tax on profits at a rate of 19% from 1 April 2017 (previously 20%), over and above this there can be personal income tax to be paid with regard to Salary and Dividend extractions from the business.

For extractions to be as tax efficient as possible the director normally would draw a small salary from the company within their personal allowance but not above the point at which national insurance becomes payable, this salary would be an allowable business cost for corporation tax so 19% corporation tax is saved on the gross salary. The remainder of their withdrawals would be in the form of dividends, these are paid out of post-tax profits and are not deductible expenses for corporation tax purposes so offer no tax saving, however there is no national insurance to pay on dividends. This is covered in some depth on Factsheet 1.

In the 2017/18 tax year dividends are taxed at 7.5% in the basic rate of tax, with rates of 32.5% & 38.1% in higher and additional rates respectively. The first £5,000 of dividends that would otherwise be taxable at the above rates are currently subject to a tax-free allowance (called the 'dividend allowance').

Comparison One really important point worth considering is the tax savings where the business owner retains some post-tax profits within the limited company. A sole trader must pay tax on the profits whether the money is required to be drawn personally or not. There is no requirement for the owner to withdraw all profits from the business if they do not want to, and indeed it can prove tax efficient to leave some profits retained in the company for extraction later.

In the table below we outline the tax savings of a limited company compared to a sole trader for different levels of profits based on the 17/18 tax year. We have assumed an optimum level of salary and dividends in the scenario of a limited company and the figures include national insurance payable as a sole trader.

	Limited Company		Sole Trader		
Profit £k	Tax & NI	Take Home Pay	Tax & NI	Take Home Pay	Addn Take Home Limited Company £k
10	0.3	9.7	0.3	9.7	(0.0)
15	1.3	13.7	1.5	13.5	0.2
20	2.3	17.7	2.9	17.1	0.6
25	3.6	21.4	4.4	20.6	0.8
30	4.9	25.1	5.8	24.2	1.0
35	6.1	28.9	7.3	27.7	1.2
40	7.4	32.6	8.7	31.3	1.4
45	8.6	36.4	10.2	34.8	1.6
50	9.9	40.1	12.3	37.7	2.4
55	11.4	43.6	14.4	40.6	3.0
60	13.7	46.3	16.5	43.5	2.8
65	15.9	49.1	18.6	46.4	2.6
70	18.2	51.8	20.7	49.3	2.5
75	20.5	54.5	22.8	52.2	2.3
80	22.7	57.3	24.9	55.1	2.1
85	25.0	60.0	27.0	58.0	2.0
90	27.3	62.7	29.1	60.9	1.8
95	29.5	65.5	31.2	63.8	1.6
100	31.8	68.2	33.3	66.7	1.5

So for example looking at this table, comparing the tax rates on sole trader or limited company, you can see that for profits of £40,000 the tax and NI for a sole trader totals £8.7k compared to the combined tax of a limited company (corporation tax on profits and income tax on dividends) totalling £7.4k, so there is a £1.3k saving by using a limited company.

Whilst there are tax savings at all levels of profitability the extra administration costs (discussed further in this article) can exceed the tax benefits at lower profit levels.

Going forwards the corporation tax rate is planned to decrease to 17% by 2020. At a rate of 17%, with all other variables remaining equal, the annual tax saving of incorporating a business at all profitability levels becomes even more beneficial.

Another thing to consider is that if you are married then there may be the opportunity to give your spouse some of your shares so that they can receive some of the dividends – however this is something that should be discussed in detail with an accountant.

Expenses There are subtle differences in the types of costs that are allowable for tax purposes and the way they can be claimed between the two types of entity, self employed or limited company.

As a director of a limited company you are considered an employee therefore can access a range of tax free benefits and perks. One of the most common of these is being provided with a mobile phone or a computer. So long as there is some business use these items can be provided tax free. As a sole trader you would need to add back to profits any private use element of any type of equipment.

It should be considered that in both types of business structure expenses claimed need to be wholly and exclusively for the purposes of the trade of the business.

One of the key differences is in regard to pension contributions. As a sole trader you can gain tax relief on payments into a pension but these amounts can be fairly restricted dependent upon your level of income. As a director the rules can be more generous, the company may pay a contribution into your pension of up to £40,000 per tax year (based on 17/18 rates) and more in some cases where there has been little by way of pension contributions in the preceding years. Company pension contributions on the whole will usually also be an allowable cost for corporation tax purposes (HMRC look at the combination of salary and company pension contributions to ensure the total 'remuneration' is not excessive).

Administration Of the two business structures, operating as a sole trader has the advantage of simplicity. When setting up you simply need to contact HMRC and register for self-assessment. Every year that you are self employed you will be required to file a self-assessment tax return and pay any tax due by the 31st January following the end of the tax year in question. On the tax return you will need to declare your sole trader income and expenditure, in some cases where your annual sales are below the VAT threshold (£85,000 for the 2017/18 tax year) you are simply able to report three figures on the return – being total sales, total expenditure and the profit made. Your tax return will also need to declare any further income received from other sources. You don't need a fancy book-keeping system, often a simple spreadsheet will be fine.

Trading as a Limited Company is generally more complicated. Initially you need to check if the company name is available as two separate companies cannot trade with the same name or names that are too similar. Once you are comfortable with the name you must register this with Companies House who will provide an incorporation certificate showing the company number and confirming the company is now a legal entity. A limited company has shareholders, who own the company, and the shareholders appoint directors to run the company on their behalf. The two positions are often held by the same people but it's important to understand the differences. Dividends are paid to shareholders, and salaries are paid to the directors.

As a director of a limited company you have certain legal duties that must be fulfilled in order to comply with the companies act. These include, but are not restricted to:

- Maintaining full & accurate accounting records
- Prepare and filing of annual accounts with companies house
- Filing of an annual return, detailing the details of directors and shareholdings etc. (now called a 'confirmation statement')
- Ensuring that the company complies with relevant tax and employment law
- A limited company is usually required to file its full accounts and corporation tax returns with HMRC and abbreviated accounts with Companies House, as well as an annual return with Companies House. The corporation tax is usually due for payment within 9 months of the companies year end.

In most cases the directors of a company will need the assistance of an accountant. A good accountant will ensure that the required documents are filed on time and also that the company is maximising its tax efficiency in regard to extractions by the directors/shareholders.

Other benefits of limited company There are several non-financial benefits that exist as a result of trading as a limited company. Possibly the most significant is that of limited liability status. In the event of a limited company incurring an unforeseen liability (such as a legal claim) in most cases this liability will be limited to the assets owned in the name of the company. For a sole trader there is no such distinction between personal and business assets as the business and the individual have no separate legal status. Therefore personal assets such as the family home could be at risk.

The perception of a business can be different dependent upon the trading vehicle it operates as. Simply by trading as a limited company a reputation can be enhanced as it can give the potential customer a sense of permanence and credibility compared to a sole trader – to some people a limited company looks more like a proper business.

Summary You can see from this article that choosing between a sole trader or limited company involves many tax and non-tax issues. Overall, trading as a limited company can offer benefits of both security and tax advantages at certain profitability levels, however every business is different and a one size fits all approach is not suitable, particularly given the recent changes to the taxation of dividends.

We strongly recommend that if you are considering a sole trader vs limited company that you seek the advice of an experienced and qualified accountant to advise you on your specific circumstances.