NEEDHAM ACCOUNTANCY LIMITED

A private limited company advantages versus sole trader basic accounts

A private limited company advantages and disadvantages compared with retaining sole trader status extends beyond purely tax advantages. There are other private limited company advantages and also disadvantages particularly in regard to limited company accounts and administration compared to producing a simple set of sole trader basic accounts.

A private limited company advantages include:

1. Limitation of Liability
There is no distinction between business money and personal money for anyone self employed as all business debts are the personal responsibility of the sole trader. The private limited company advantages are that the company is a separate corporate body and liability for payment of debts stops with the private limited company. The owners and shareholders are not personally liable. The directors are only liable if they continue to trade and incur liabilities after it becomes apparent the limited company is insolvent.

2. Lower Taxes
Lower corporation tax has offered a private limited company advantages over self employment in recent years. Current corporation tax rates (to 31 March 2011) are 21% for profits up to £300,000 and 28% for profits above that.

Legislation was introduced to cut the main rate of Corporation Tax to 27 per cent for the financial year starting 1 April 2011. There will be further cuts in the main rate in future years: 26 per cent in 2012-13, 25 per cent in 2013-14, 24 per cent in 2014-15.

The small profits rate of Corporation Tax for the financial year 2011-12 will be 20 per cent.

The private limited company advantages come from the flexibility of being able to determine the proportions of salary and dividends taken compared with a sole trader whose basic accounts are subject to tax at fixed tax rates and thresholds.

For 2010/11 a sole trader receives a £6,475 personal allowance and pays basic rate tax of 20 per cent on the next £37,400 of earnings up to the higher threshold limit and 40 per cent tax thereafter. Class 4 national insurance is 8 per cent of earnings up to the upper primary threshold and 1 per cent thereafter. For 2011/12 a sole trader will receive a £7,475 personal allowance and will pay basic rate tax of 20 per cent on the next £35,000 and Class 4 national insurance will be 9 per cent of earnings up to the upper primary threshold and 2 per cent thereafter.

There are three different Income Tax rates on UK dividends. The rate you pay depends on whether your overall taxable income (after allowances) falls within or above the basic or higher rate Income Tax limits.

Dividend income in relation to the basic rate or higher rate tax bands	Tax rate applied after deduction of Personal Allowance and any Blind Person's Allowance
Dividend income at or below the £37,400 basic rate tax limit	10.0%
Dividend income at or below the £150,000 higher rate tax limit	32.5%
Dividend income above the higher rate tax limit	42.5%

There are significant private limited company advantages regarding tax liability compared to a sole trader where net income is below the upper earnings threshold.

For example assuming the limited company net profit before salary is £35,000. A sole trader would pay income tax of £5,725 plus national insurance of £2,282, a total of £7,987.

If a salary of £6,475 is taken and the rest is taken in dividends a private limited company would pay £6,082.65 corporation tax, after deducting the salary from net taxable profit and the sole trader now the shareholder would pay no income tax.

The advantages increase where net taxable profit is above the self employment upper earnings limit as money can be left in the business and therefore only subject to the 20 per cent corporation tax rate thereby avoiding the sole trader 40 per cent tax rate. Another possibility is to distribute the shares among family members to reduce the risk of 40 per cent tax.

3. Limited Company accounts and Sole Trader basic accounts

Sole trader basic accounts can be quite simple as a formal accounting system is not required and can be reduced to simple lists of income and expenditure supported by documentary evidence of sales and purchase invoices, effectively single entry bookkeeping. Producing a balance sheet is optional. Due to the simplicity then an accountant may not be required saving a significant cost.

Limited company accounts have to use double entry bookkeeping to produce the year end accounts including a balance sheet with statutory notes and statements. Unless accounting software is employed to produce the company accounts in this format then accounting knowledge is required and an accountant's fee may well have to be paid. An accountant is not essential for a small private limited company but is the normal approach and offsets some of the tax advantages.

4. Additional financial considerations

Because a director is also officially an employee of the private limited company this gives rise to a number of considerations in determining the extent of a private limited company advantages.

Pension contributions of a sole trader are personal and while may they be deducted from the personal income liability they do not form part of the basic accounts. The pension costs including any company contribution to a pension scheme by a private limited company is a deductible business expense as an employee cost.

Using a car for business purposes may have an impact. The sole trader basic accounts would include the business proportion of the vehicle running costs or the mileage allowance. If that vehicle is used by a director then that director is receiving a taxable benefit potentially resulting in a higher tax burden depending upon the type of vehicle as taxable benefits vary. An alternative may be to leave the company vehicle privately owned and the director claim mileage allowances rather than vehicle running costs.

Potentially small issues but there differences in the accounting treatment of deductible expenses such as charitable donations, entertaining expenses and use of home as office. A private limited company advantages consist of being able to claim such expenses as valid business expenses which would not be claimable in the sole trader basic accounts as treated as personal not business.

If the director and main shareholder have other associated companies then the corporation basic tax rate could be affected.

5. Administration, management and business standing

A sole trader basically pleases themselves with regard to the administration and management of the business. A company director is responsible for adhering to company administration according to statutory regulations in regard to both the limited company accounts, statutory books and management as stated in the articles of association. The duties of a director are more formal than a sole trader.

Forming a private limited company is an indication that a business is both serious, has a long term objective and is correctly managed. This psychological perception can increase the business standing of a business. In addition funding requirements are more likely to be met as the lender to a sole trader has to consider the absence of a balance sheet statement in the basic accounts and the financial influences personally affecting the sole trader. A private limited company advantages concern the published financial statements, protection of the financial position from personal influences and the option of increasing security by virtue of asking directors to provide additional personal guarantees.

A private limited company advantages over self employment also extends to long term finance. Companies tend to retain more funds within the business to meet future financial commitments which aids year on year growth, a more sustainable business and medium term profits growth over a sole trader.