MARCH 2023

HOW TO CHANGE FROM SOLE TRADER TO LIMITED COMPANY

COMPANY FORMATION

The tax imbalance and disparity of financial security between different types of self-employed workers and small business owners in the UK leads many people to consider the benefits of converting from sole trader to limited company.

To help you to make an informed decision, we discuss the key differences between these two popular business structures.

WHAT IS A SOLE TRADER?

A sole trader business is owned and controlled by one self-employed individual. There is no legal distinction between you and the business – you are one and the same in the eyes of the law. This is hugely significant because it means that, as a sole trader, you have unlimited personal liability for any and all business debts, losses, and legal claims.

Consequently, your personal finances and assets, including your home and savings, are at risk if you are unable to pay business-related debts or if you are sued during the course of running your business. In a worst-case scenario, this could result in personal bankruptcy.

WHAT IS A LIMITED COMPANY?

A limited company is owned by one or more shareholders and managed by one or more directors. The same person can be a shareholder and a director, so you have the option to own and control the business by yourself (just like you do as a sole trader) or jointly with other people.

A limited company has its own legal identity. It is liable for its own debts, losses, and any claims brought against the business. This means that the company's finances, liabilities, and actions are completely separate from those of its shareholder(s) and director(s).

As a result, company owners enjoy limited liability. Beyond what they invest in the company or agree to contribute, their personal finances and assets are protected if the business can’t pay its bills or is sued.

Limited liability is reason enough for many self-employed people and small business owners to set up a limited company from the get-go or convert from sole trader to limited company at a later stage. However, there are many more benefits, which we highlight below.

SOLE TRADER VS LIMITED COMPANY: THE KEY DIFFERENCES

Sole trader and limited company business structures are the most popular options for people who want to work for themselves, but there are significant differences between the two.

Setting up as a sole trader is the go-to business structure for many self-employed individuals in the UK because it's a straightforward way to start and run a business. That being said, a limited company is the most secure and tax-efficient option for almost all types and sizes of businesses, offering far greater benefits than operating as a sole trader.

If you are thinking about converting from sole trader to limited company, it will be helpful to understand these key differences, as well as the advantages and disadvantages of both structures.

1. REGISTRATION AND INTERNAL BUSINESS STRUCTURE

Sole trader	Limited company
Registered through HMRC	Registered (incorporated) at Companies House
No cost to register a sole trader business	Small incorporation fee payable to Companies House
You can trade using your own name or another name. There is no need for this name to be registered	A unique company name must be registered at Companies House during the incorporation process Stricter rules and requirements apply to company names
No legal distinction between owner and business – you are the business; the business is you	A company is a distinct legal 'person' that is separate from its owner(s)
Unlimited liability – you are held personally responsible for business debts and legal disputes If your business fails, you are at risk of personal bankruptcy	Limited liability – the company is held responsible for business debts and legal disputes (limited exceptions apply) If the business fails, the company is at risk of insolvency (i.e. corporate 'bankruptcy'), not the shareholder(s) or director(s)
Owned by one person only	Can be owned by one or more people, who are known as 'members' or 'shareholders' Managed by one or more people, who are known as 'directors' Shareholders and directors can be the same people

You are self-employed	You are employed by the company as a director, which means that you may be eligible for certain employee benefits
Must provide HMRC with a business contact address. This is not available to the public unless you include it on business stationery or other forms of communication or marketing material	The company must have a registered office address in the country of incorporation Every director and shareholder must provide a service ('correspondence') address Both of these addresses are a matter of public record
If a sole trader dies, the business ceases to exist	If the sole shareholder and director of a company dies, the company still exists in its own right. This is known as 'perpetual succession'
As a rule, a number of industries and agencies will not work with self-employed freelancers or sole traders	Depending on the industry in which you operate, you may find that having limited liability protection offers a greater choice of clients and contracts

2. BUSINESS INCOME AND TAXATION

Sole trader	Limited company
All business income belongs to you	Business income belongs to the company until it is transferred to you as: • A director's salary • Expenses • Shareholder dividends • A director's loan
You pay Income Tax (20-45%) and National Insurance contributions (Class 2 and Class 4) through Self Assessment on all declared business profits above your tax-free Personal Allowance (PA)	You pay Income Tax and Class 1 National Insurance contributions (NIC) through PAYE on your director's salary (above your Personal allowance) You pay dividend tax (8.75%-39.35%) and NIC (Class 2 and Class 4) through Self Assessment on dividend income above your PA and the £1,000 tax-free Dividend Allowance. These tax rates are lower than Income Tax rates The company pays a flat rate of between 19% and 25% Corporation Tax on all taxable profits. This is lower than Income Tax rates. You can minimise your personal tax and NIC liabilities by taking a lower salary and higher dividends
You cannot pay a spouse or partner through the business unless it is commercially justified	If your spouse or partner is a basic rate taxpayer or is not in receipt of any income, you could avoid higher tax bands by making your spouse or partner a shareholder

The deadline for paying your Income Tax and NIC liabilities on your sole trader income is 9 months after the end of the tax year	Income Tax and NIC are deducted from your salary immediately through PAYE You do not have to pay tax or NIC on your dividends until 9 months after the end of the tax year
You cannot keep profits in the business in order to defer tax until a future tax year	You can defer tax on profits by leaving surplus income in the company to withdraw in a future tax year This is a great option if withdrawing all profits in one year would result in your paying a higher rate of personal tax
Your ability to borrow capital for business purposes is based on your personal credit rating You are personally liable for business loans; therefore, your own credit rating will be impacted if you default on a business loan or are unable to pay it back	A company can establish its own credit profile and borrow capital in its own name The company will be liable for business loans taken out in its name; therefore, it is the company's credit profile that will be adversely affected if it defaults on a business loan or fails to pay it back

3. ACCOUNTING, REPORTING, AND RECORD-KEEPING REQUIREMENTS

Sole trader	Limited company
No information about you or your business is made available to the public by HMRC	Company information is a matter of public record, including accounts and certain details relating to directors and shareholders
No annual filing or maintenance fees	A Confirmation Statement must be sent to Companies House every year to confirm/update certain company details. This costs £13
No legal requirement to keep or submit accounts, though it is beneficial to do so	It is a legal requirement to prepare annual accounts for Companies House and HMRC
Must register for Self Assessment Must report your self-employed income by sending a Self Assessment tax return to HMRC every year	The company must register as an employer and set up PAYE, even if you (the director) are the only employee The company must operate payroll to pay, record, and report your director's salary A Company Tax Return must be delivered to HMRC each year If you are a shareholder as well as a director, you must register for Self Assessment and send a personal tax return to HMRC every year to report your total annual income from all sources (salary, dividends, any other earnings)
Keep records of all sales and expenses	Keep accounting records and company records, including a number of statutory registers that must be made available for public inspection

4. EXPENSES AND BENEFITS

Sole trader	Limited company
Only eligible for a personal pension scheme	Access to more favourable, tax-efficient, and customisable pension scheme options through a company
You can claim capital allowances on your car, but you must disallow a proportion for the private use of the vehicle	Companies are eligible for full capital allowances on cars, regardless of any private use
Tax relief on mobile phones and computers will be apportioned according to business and private use – an add-back of capital allowances will apply	Mobile phones and computers are tax-free if they are purchased by the company More tax-free benefits available through a company, parking charges, public transport, travel costs, health checks, eye tests and prescription eyewear, childcare, and school fees
You can't charge yourself rent for the use of your home for business purposes	You can charge rent to the company for the use of your home for business purposes, which will enable you to offset a proportion of your mortgage interest and council tax

HOW MUCH DOES IT COST TO SET UP AND MAINTAIN A LIMITED COMPANY?

Companies House charges a small incorporation fee to set up a limited company. We offer an incorporation fee of £60 + VAT. This includes:

- A ready-to-trade limited company incorporated at Companies House in around 48 working hours (subject to Companies House workload)
- Expert help and guidance throughout the company formation process and beyond
- All company registration documents, including a Certificate of Incorporation, Share Certificates, a Memorandum of Association, and Articles of Association
- Optional services are available, including company address services, PAYE and VAT registration.

The only statutory cost of maintaining a limited company is £13/ year, which you must pay when you file an annual Confirmation Statement at Companies House.

You will also need to file annual accounts at Companies House 21 months after company formation, then every 12 months, as well as deliver a Company Tax Return and accounts to HMRC every year.

Whilst there are no filing fees to pay, we rarely see clients that do not have an accountant when operating as a limited company, particularly if you are not confident with bookkeeping and accounting or if your business finances are complex.

The typical cost of using an accountant ranges from £750 to £1,500 a year for preparing accounts and tax returns, depending on how accounting records are maintained and the level of service required and tax advice needed.

This may seem like a significant sum, but for many business owners, it’s a small price to pay for financial peace of mind, in addition to the prestige, tax advantages, and the limited liability protection of a limited company.

CONVERTING YOUR BUSINESS FROM SOLE TRADER TO LIMITED COMPANY

If you decide to convert your existing small business from sole trader to limited company, you will need to take the following steps:

1. REGISTER A LIMITED COMPANY

The first step is to register a limited by shares company.

To register a limited company online, you will need:

- A unique company name
- A registered office address
- At least one director
- At least one shareholder
- A service address for each director and shareholder
- Standard Industrial Classification (SIC) code(s) to describe the nature of your business activities

Limited company names are subject to more rules and restrictions than sole trader names.

2. TELL HMRC THAT YOU HAVE DECIDED TO STOP BEING A SOLE TRADER

When your new company has been incorporated, and you are ready to start trading through this business structure, you must tell HMRC that you are stopping self-employment and will cease running your business as a sole trader. To do this, you must complete an online form with the following details:

- The date on which you stopped being self-employed
- Unique Taxpayer Reference (UTR)
- National Insurance Number
- Name
- Date of birth
- Address
- Nature of trade

You will need to send a final Self Assessment tax return as a sole trader by 31st January after the end of the tax year. The income reported on the return should include your self-employed earnings and tax liability up to the date on which you stopped being a sole trader.

You may also need to include:

- Allowable expenses, including any costs involved in converting your business structure
- Capital allowances on any sole trader assets transferred to your limited company
- Capital Gains Tax (CGT) on any business assets transferred to the company

3. TRANSFER YOUR SOLE TRADER BUSINESS TO THE COMPANY

Depending on the nature of your sole trader business, you may need to transfer your existing business assets (such as property, machinery, equipment, inventory, etc.) to your new limited company.

Naturally, your new company is unlikely to have available funds to pay for these assets. In this situation, the most common approach is to create a director's loan account whereby the company will pay you (the director) for the transferred business assets over time.

Transferring certain assets may trigger Capital Gains Tax (CGT) liability, which will be based on the market value of the assets.

Depending on your specific circumstances, you may be able to reduce or defer CGT by claiming some form of tax relief, such as Incorporation Relief, Business Asset Disposal Relief (formerly Entrepreneurs' Relief), or 'Hold-over' Relief.

Transferring assets can be complex for some businesses, so we advise speaking to an accountant for expert help and advice.

4. SET UP A BUSINESS BANK ACCOUNT IN YOUR COMPANY NAME

There is no legal requirement for sole traders to operate business bank accounts. However, keeping your business finances separate from your personal finances is advisable.

The limited company must have a business bank account in its own name.

5. NOTIFY STAKEHOLDERS ABOUT THE CHANGE OF BUSINESS STRUCTURE

You will need to inform a number of parties that you have changed the legal structure of your business and will now be operating through a limited company.

The stakeholders that you will have to notify include (where applicable):

- Employees and contractors
- Customers and clients
- Suppliers and service providers
- Banks, lenders, and other finance providers
- Landlords
- Debtors

By informing all interested parties, you are keeping everyone abreast of important changes to your business, minimising any risk of confusion or voiding contractual agreements, and ensuring all paperwork and invoices contain the correct details.

You may also need to provide certain parties with your new business bank account details.

6. REGISTER YOUR LIMITED COMPANY FOR TAX AND PAYE

When your new company has been incorporated, Companies House will inform HMRC. You will receive a letter from HMRC at your company's registered office address within approximately 2 weeks of company formation.

This will contain information about your tax and reporting obligations and your company's 10-digit Unique Taxpayer Reference (UTR).

You must register your company for Corporation Tax online within 3 months of starting to trade through this new structure. To do so, you will need your company UTR and Company Registration Number to hand.

If you expect your VAT taxable turnover to be more than £85,000 within a 12-month period, you must register the company for VAT. Alternatively, you may wish to voluntarily register for VAT to improve your company's tax efficiency and status. If your sole trader business is registered for VAT, you should cancel this existing registration within 30 days of changing your business structure.

To receive a director's salary and pay employees (if you have any), you must register as an employer and set up Pay As You Earn (PAYE) before the first payday. You can choose to operate PAYE using payroll software or appoint a payroll provider to take care of this for you.

TAKE-HOME PAY COMPARISON: SOLE TRADER VS LIMITED COMPANY

Compared to the sole trader structure, a limited company provides the opportunity for many freelancers and small business owners to reduce their tax and NIC liabilities, providing them with higher take-home pay. Below is a simple example based on a trading profit of £50,000 for the coming 2023/24 tax year.

Limited company		Sole trader	
Profits before adjustment limited company	50,000	Self employment profits	50,000
Directors salary	12,570	Income Tax	7,486
Employers NIC	100	National Insurances	3,870
Profits for corporation tax	37,330	*Net Income*	38,644
Corporation tax payable	7,093	NET VARIANCE	1,518
Available for dividend	30,237		
Dividend tax	2,646		
Net Income	40,162		

By trading through a limited company, a tax saving of £1,518 can be achieved on a £50,000 trading income – without factoring in any tax-deductible costs and expenses of running the business.

However, remember that you may have to pay accountancy fees if you need more confidence in dealing with company bookkeeping and accounting requirements.

IS IT WORTHWHILE CONVERTING FROM SOLE TRADER TO LIMITED COMPANY?

There are some great benefits to setting up a limited company, which we've highlighted above, making it a worthwhile decision for many people. However, it is not a one-size-fits-all structure, nor is there a set point at which converting to a limited company is a necessity.

More often than not, converting from sole trader to limited company is simply a matter of personal preference. Ask yourself:

- Will I pay less tax and receive a higher take-home pay through a limited company?
- Will a limited company's prestige help me attract more clients and grow my business?
- Should my business fail, could I benefit from my personal assets being protected?
- Do I want to bring in business partners or attract investment?
- Are these benefits worth the extra administration and filing requirements?

Your choice of business structure depends on your circumstances and what you are comfortable with. If you are unsure about the best course of action, you should seek tailored, professional advice from an accountant.

QUESTIONS? GET IN CONTACT WITH US!

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