

Sole trader, partnership or company?

(Lecture P1129 – 11.43 minutes)

A common question asked of us by clients who are starting in business is “Should I be a Sole Trader or a Limited Company?” or words to that effect. In the case of two people venturing into business together – such as a husband and wife – the word “Partnership” can also be thrown into the mix.

The answer of course – as it usually is to questions of this nature – is the old chestnut, “It Depends”.

“It Depends” on profit levels, how much the proprietors wish to draw from the business, whether the clients have other income sources, whether the concept of limited liability is important to them, what their long-term succession plans are and whether they have the organisational discipline to deal with the extra compliance burdens placed on them by running a business through a company.

With all these factors, there can never be a “One Size Fits All” solution, particularly as the optimum choice of business medium will often change as the business develops and matures.

To give us a general picture of how to decide on a business vehicle, these notes will take a small business, run jointly by a husband and wife, and look at the net distributable post-tax profits which are available to be drawn by the owners based on whether the business is either run:

- (a) By one of the parties as a Sole Trader with the other acting as an employee;
- (b) By the parties as 50:50 Partners;
- (c) By the parties as 50:50 director / shareholders of a Limited Company.

We will look at distributable post-tax profits from a range of profit levels between £20,000 and £150,000. This should give us a big enough sample size to draw some conclusions. In all cases we will assume that:

- 2018/19 UK (non-Scottish) rates and allowances apply;
- FA18 corporation tax rates apply (being 19%);
- Any salaries / director’s fees are paid at the level of the Class 1 NIC primary and secondary earnings threshold (£8,424) as this creates an entitlement to retirement benefits without triggering a NIC liability for the employee or the business (with the added bonus that the salary is tax-deductible). We will assume that sufficient care is taken by the business not to contravene National Minimum Wage legislation;
- The client has no other income (so the personal allowance of £11,850 is available against business income); and
- Post-tax profits are fully distributed to the owners either as drawings or dividends.

When doing all of this we do recognise that we are allowing the tax tail to wag our business dog, but we are tax people after all so please indulge us.

The Answer...

Here is a Table that shows the comparable results for post-tax profits available to the proprietors from the various business mediums based on a business owned and managed by a husband and wife team on business profits ranging between £20,000 and £150,000.

The detailed workings behind the numbers are in the Appendix at the end of this article.

Business profit (before salaries):	Post-tax spendable profits		
	Sole Trader	Partnership	Limited Company
	£	£	£
£20,000	19,563	19,410	19,401
£35,000	30,268	30,800	31,551
£50,000	40,918	41,450	43,701
£100,000	70,539	76,002	82,714
£150,000	95,799	105,002	119,801

What conclusions can we draw?

- Trading through the vehicle of a limited company offers consistent tax savings and maximises post-tax profits at profit levels over £20,000 with tax savings increasing in the higher profit ranges. However, if we factor in the additional compliance costs (in both money and time) of running a limited company, there is a good argument for retaining an unincorporated structure while profit levels remain at no more than £35,000 - £40,000. This does not, of course, factor in the issue of limited liability protection on which it is difficult to put a price.
- The above comparisons assume that all post-tax profits are distributed to the shareholders as dividends. Retaining profits in the company structure will save tax at the higher profit levels as income tax liabilities at 32.5% is avoided. In these cases, the most tax-efficient strategy is likely to be to draw sufficient dividends to utilise the shareholder's basic rate band without triggering a higher rate income tax charge. This will allow each shareholder / director to extract a salary of £8,424 and a dividend of £37,926.
- This allows total drawings of £46,350 x 2 = £92,700 at a tax cost of just £2,427 x 2 = £4,854 (an effective personal tax rate of a little over 5%). For businesses with profits big enough to absorb this level of drawings, this is hard to beat.

Corporate structures offer the easier way to pass the business to the next generation or to involve a family member by giving away an equity stake while still retaining control.

So, "Should I be a Sole Trader or a Limited Company?". The answer is probably to start off as an unincorporated business, particularly if early year losses are anticipated whilst the business is investing in its future and establishing its place in the market. The loss set-off rules for individuals are far more generous than for companies as losses in the first 4 tax years can be carried back 3 years against general income to generate repayments.

Then as the business grows, profits increase and the legal issues get more complicated, incorporate the business and work under the umbrella of limited liability protection with added tax savings to boot.

APPENDIX - DETAILED WORKINGS

SOLE TRADER:

Trader employs wife / husband in the business on a salary of £8,424.

	£	£	£	£	£
Business profits	20,000	35,000	50,000	100,000	150,000
Less: Employee salary	(8,424)	(8,424)	(8,424)	(8,424)	(8,424)
Taxable	11,576	26,576	41,576	91,576	141,576
Income tax	Nil	2,945	5,945	24,990	49,730
Class 2 NIC	153	153	153	153	153
Class 4 NIC	284	1,634	2,984	4,318	4,318
Total tax & NIC	437	4,732	9,082	29,461	54,201
Net distributable	19,563	30,268	40,918	70,539	95,799

Notes:

- Salary must be paid and reasonably commensurate with duties performed.
- Where profits are £150,000, personal allowances are reduced to nil.
- Class 2 NIC no longer due for abolition.
- Net distributable amount includes the employee salary (as retained in family).

PARTNERSHIP:

Profits split 50:50 between husband and wife

	£	£	£	£	£
Business profits	20,000	35,000	50,000	100,000	150,000
50% each	10,000	17,500	25,000	50,000	75,000
Income tax	Nil	1,130	2,630	8,360	18,360
Class 2 NIC	153	153	153	153	153
Class 4 NIC	142	817	1,492	3,486	3,986
Total tax & NIC	295	2,100	4,275	11,999	22,499
x 2	590	4,200	8,550	23,998	44,998
Net distributable	19,410	30,800	41,450	76,002	105,002

Notes:

- The tax position would be the same if the business was run as a Limited Liability Partnership (LLP) with the members then being entitled to limited liability protection.
- This assumes each partner plays an active role in the business and that HMRC does not seek to reallocate profits under the settlements legislation.

LIMITED COMPANY:

Husband and wife as 50:50 shareholder / directors.

Each takes a director's fee of £8,424.

Balance of profits distributed by dividend.

	£	£	£	£	£
Business profits	20,000	35,000	50,000	100,000	150,000
Less: Director's fees	(16,848)	(16,848)	(16,848)	(16,848)	(16,848)
Liable to corporation tax	3,152	18,152	33,152	83,152	133,152
CT @ 19%	599	3,449	6,299	15,799	25,299
Balance paid as dividends	2,553	14,703	26,853	67,353	107,853
50% each	1,276	7,351	13,426	33,676	53,926
Income tax	Nil	Nil	Nil	1,487	4,900
Net distributable	19,401	31,551	43,701	82,714	119,801

Notes:

- £2,000 dividend allowance applies.
- No NIC on dividends.