Pros and Cons of Incorporation

Factsheet

Introduction

There were about 5.5 million businesses in the UK in 2025. These businesses range from people doing small side gigs to global corporations such as Vodafone. Of these business, 2.5 million were limited companies.

It's common for most business owners to consider whether they should incorporate their business. Incorporation involves the formation of a separate legal entity from the founder, a limited company. This is done by registering a new company at Companies House.

Operating through a limited company brings very different legal and tax obligations to working as a sole trader. To help business owners understand these, this factsheet summarises the main differences between running a business as a sole trader and through a limited a company.

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Top tip

Our website has a wealth of free resources to help you start your business.

For factsheets about business planning, how to price your products, employment issues and more, check out our free resources at parryandparry.co.uk/resources

Pros and Cons of Incorporation

Differences between sole traders and companies

Item	Sole Trader	Limited company
Legal form	You are the business. You can give the business a trading name but that is not officially registered anywhere.	The business is a separate legal entity. The company is registered at Companies House and other companies will not be able to have the same name.
Ownership	You are the business.	You are a shareholder; you hold all or a proportion of the company's share capital
Legal liability	In the event of a legal dispute you will be sued personally, meaning that your personal assets are at risk if a judgement is passed against you. You may have insurance to mitigate some of these costs (eg public liability or professional indemnity insurance)	In the event of any legal dispute the company will be sued. The company will be liable for any costs or losses associated with any adverse judgements. In normal circumstances only the value of the proportion of the business you own is at risk, not your personal assets. It is exceptionally difficult and rare under UK law for anyone to sue a director personally for a company's wrong doing. There are exceptions where the "corporate veil" may be lifted and a director may be held personally accountable.
Employment status	You are self employed.	A director is an office holder, this does not automatically make them an employee in terms of employment law, tax or benefits purposes. You may also be a shareholder (ie owner) of the company but legally this role is separate from your role as a director.

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Tax	You are taxed. You pay Income Tax and Class 2 and 4 National Insurance on the profits of your business.	The company pays Corporation Tax on its taxable profits. Post tax profits can be paid as dividends to shareholders. The shareholders' dividends are taxed as income through dividend tax in their self assessment. Dividend tax is lower than Income Tax.
How you are paid by the business	You are the business, so any residual profit is your "payment".	Directors can receive a salary. This requires a formal payroll to be registered with HMRC and operated. If you are also a shareholder retained post tax profits can also be paid to you as a shareholder. Further small tax free allowances are also available.
Pension	You can have a personal pension	The company can operate a pension scheme or contribute to directors' personal pensions. This is often quite tax efficient.
Business expenses - principles	You may charge business expenses to the business as long as they are wholly and exclusively for the purposes of the trade. The business will obtain tax relief for all business expenses (except very specific exceptions, such as business entertaining). Costs that involve some degree of personal use can only be claimed on a proportionate basis.	The company should pay for all business expenses. The company will obtain tax relief as long as they are incurred wholly and exclusively for the purposes of the trade. Personal expenses paid for by the company are treated as a taxable benefit (except for a few exceptions) and are taxed as part of the director/employee's income.

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Accounts and tax returns	There is no requirement for sole traders to file accounts at Companies House. Currently sole traders below the VAT threshold (sales of £90,000 in a 12 month period) may use a very basic format for submission of accounts to HMRC. This is due to change in the near future. HMRC is planning to require sole traders to submit quarterly information. This is called "Making Tax Digital for Income Tax". The implementation has been pushed back and is currently likely to be a requirement in April 2026. Where accounts are prepared, they must be completed in accordance with Generally Accepted Accounting Practices.	Annual financial statements must be prepared for every financial year of the company. These must be filed at Companies House and can be accessed by the public. Abbreviated accounts, with limited information can be filed for small companies. The financial year end is normally one year after the company is formed (with the actual date being the end of the month). A copy of the detailed financial statements must also be filed with HMRC as part of the annual Corporation Tax return.
Administration	Must be registered with HMRC as self employed	Companies House must be updated with any changes to the company directors, shareholders, address etc. The company will have a written constitution called the Articles of Association and Memorandum of Association. More often than not a standard template is used for both of these documents. Board minutes need to be generated for key decisions. Normally your appointed company secretary or accountant will do this for you.
Commercial agreements	All commercial agreements (sales contracts and supplier contracts) must be between you and your customers/suppliers.	All commercial agreements must be between the company and its customers and suppliers.

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Insolvency	If the business fails you are personally liable for any debts.	If the company fails shareholders' liability is limited to the assets of the company. A director can be held personally liable if the company "wrongfully trades" when it is insolvent and falls into administration.
Selling the business	When the business or assets used in it are sold you are personally taxed on any gain under the Capital Gains Tax rules. A disposal of an interest in a business or business assets may qualify for Business Asset Disposal Relief ("Entrepreneurs' Relief") which reduces the tax due considerably.	There are two ways to dispose of the business. The first is to sell the shares of the company. This means you sall full ownership of the company in its entirety. Alternatively the business can sell the assets of its business. In this scenario the shareholders would retain ownership of the "shell" company. A disposal of shares will give rise to a Capital Gains Tax charge on the shareholders. Again, this may be partly or wholly relieved by the Business Asset Disposal Relief.
Death	When you die the business ceases. You can pass the assets of the business to your beneficiaries. Business Property Relief will apply for Inheritance Tax purposes if the business is a qualifying trade.	When you die the company continues, it is a separate legal entity. The company's shares would pass to the beneficiaries, and would qualify for Business Property Relief for Inheritance Tax purposes.

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Reaching a decision

The correct legal form for your business will depend on a multitude of factors, timing, your ambition, your personal tax situation, other commitments etc. In our experience entrepreneurs' decisions normally boils down to the following key considerations:

	Sole trader	Limited company
Commercial risk	Favours lower risk businesses	Favours higher risk businesses
Administration	Less admin	Higher, usually outsourced to your accountant
Tax efficiency	Tends to be more tax efficient for businesses with profits under £50k (depending on your circumstances)	Tends to be more tax efficient for businesses with profits over £50k (depending on your circumstances)
Prestige	Will be seen as less prestigious to customers and others	More prestigious

Like to know more?

If you'd like to learn more, discuss any of the topics noted in this document or are ready to launch your business we'd love to talk. Contact us as hello@parryandparry.co.uk

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