TAX GUIDE · HERMIT BUSINESS SOLUTIONS

Sole Trader vs Limited Company: Tax in 2026/27

*Which structure keeps more of your profit, **the answer isn't as simple as it used to be.***

Why this matters

If you are starting out in business, or you have been trading as a sole trader for a while and are wondering whether it is time to incorporate, the tax question usually comes up first. The two structures are taxed in completely different ways, and the right answer depends on how much profit you make, how you plan to draw money out of the business, and how many other people you employ.

For a long time, the rule of thumb was simple: once profits climbed past a certain point, forming a limited company almost always saved you money. That rule of thumb still holds at higher profit levels, but recent increases to employer National Insurance and to dividend tax rates have narrowed the gap considerably and at moderate profit levels a sole trader can now come out ahead in pure cash terms.

How a sole trader is taxed

As a sole trader, there is no legal separation between you and your business. All of your trading profit is simply added to your other income and taxed as your personal income, through two separate charges.

Income Tax

You get a tax free personal allowance of £12,570. Above that, profit is taxed at 20% up to £50,270, 40% between £50,270 and £125,140, and 45% above that.

Class 4 National Insurance

On top of Income Tax, self employed profits attract Class 4 NIC at 6% between £12,570 and £50,270, and 2% above £50,270.

Class 2 National Insurance

This is no longer a compulsory charge. If your profits are above the small profits threshold (£7,105 for 2026/27), you are treated as having paid Class 2 for state pension purposes without actually handing over any cash. If your profits fall below that threshold, you can choose to pay voluntary Class 2 contributions (£3.65 a week) to protect your state pension record.

Whatever is left after Income Tax and Class 4 NIC is yours to keep. There is no separate step for drawing money out of the business, because as a sole trader there is nothing to draw it out of. It is already yours.

How a limited company is taxed

A limited company is a separate legal entity and that separation is really the whole story. The company pays tax on its own profits, and you, as director and shareholder, pay tax separately on whatever the company pays you.

Corporation Tax

The company pays 19% on profits up to £50,000 (the small profits rate), 25% on profits above £250,000 (the main rate) and a tapered rate in between through marginal relief.

Getting money out of the company

Most director shareholders take a low salary and the rest as dividends because this combination is usually more efficient than a salary alone. A common approach is to set the salary at the level of the personal allowance, £12,570, so there is no Income Tax or employee National Insurance on it.

Employer National Insurance

This is the piece that has changed the maths most in recent years. Employer NI is charged at 15% on salary above the secondary threshold of £5,000 and it is the company, not the director, that pays it. Companies can normally offset this with the £10,500 Employment Allowance, but there is an important catch: a company where the director is the only employee does not qualify for the Employment Allowance. For a genuinely one person company, employer NI on a £12,570 salary comes to around £1,136 a year, with no allowance to shelter it.

Dividend Tax

Once the company has paid Corporation Tax, whatever is left can be paid out as dividends. The first £500 of dividend income is tax free each year. From April 2026, the ordinary rate rose from 8.75% to 10.75%, and the upper rate rose from 33.75% to 35.75%. The additional rate stays at 39.35%.

So, unlike a sole trader, a limited company director's profit passes through two layers of tax before it lands in a personal bank account: Corporation Tax at company level, then dividend tax (or Income Tax and NI on salary) at personal level.

Worked example: £50,000 profit

Here is how the two structures compare for a business making £50,000 of profit for the year, assuming the limited company is a single director company with no other employees, so it cannot claim the Employment Allowance.

	Sole trader	Limited company
Trading profit	£50,000.00	£50,000.00
Director's salary	n/a	£12,570.00
Employer NI (15% above £5,000)	n/a	£1,135.50
Corporation Tax (19%)	n/a	£6,895.96
Income Tax (20% above £12,570)	£7,486.00	n/a
Class 4 National Insurance (6%)	£2,245.80	n/a
Class 2 National Insurance	£0, NI credit only	n/a
Dividend tax (10.75%, after £500 allowance)	n/a	£3,106.59
Total tax and NIC	£9,731.80	£11,138.05
Take home pay	£40,268.20	£38,861.95

What the numbers show

At this profit level, the sole trader keeps roughly £1,400 more than the single director limited company, once employer National Insurance and the higher dividend tax rates are taken into account.

Two things move that result if your situation is different. First, if the company has other employees or a second director drawing a salary, the Employment Allowance would likely wipe out the £1,135.50 of employer NI shown above, closing most of the gap. Second, the comparison changes at higher profit levels: run the same numbers at £100,000 of profit and the sole trader is still ahead, by around £4,000, but the gap as a proportion of profit is smaller, and it continues to narrow the further profits rise above the £50,270 higher rate threshold, since a sole trader is fully exposed to 40% Income Tax on that slice while the company's Corporation Tax stays well below that.

Beyond the numbers

Pure take home pay is only part of the decision, and it would be a mistake to treat the table above as the whole answer. A limited company gives you limited liability, which can matter a great deal if your business carries any real risk. It also lets you leave profit inside the company rather than drawing it all out, which is useful if you do not need all of the cash this year, want to build up funds for a future purchase, or want to make employer pension contributions, which are a Corporation Tax deductible expense and do not attract dividend tax at all. Some clients and larger customers also simply prefer to deal with a limited company. Against that, a company brings more administration: statutory accounts, a Corporation Tax return, payroll if you take a salary, and generally higher accountancy fees than a sole trader's Self Assessment return.

KEY TAKEAWAY

The gap between the two structures has narrowed enough that it is worth running the numbers for your own profit level rather than relying on old assumptions, especially if you are a single director company without other staff. If you would like help working out which structure suits your own figures, or whether the timing of a switch makes sense partway through a tax year, get in touch and we can go through it together.

What to do next

- Work out your own numbers before assuming either structure is better
- Check whether your company would qualify for the £10,500 Employment Allowance
- Get in touch for a comparison based on your actual profit and plans

Please note

Figures throughout are based on 2026/27 tax rates and thresholds as they stand for the tax year from 6 April 2026, are for illustration only, and do not constitute tax advice. Everyone's circumstances are different, so please speak to an accountant before making a decision based on these figures.