OHT Guide

Pros and Cons of Incorporation

Many start-up businesses will begin as sole trades or partnerships because of the costs of incorporation and the ongoing compliance costs associated with a company. However, as a business grows and turnover and profits increase, business owners may consider the benefits of incorporation, and in particular the attractions of limited liability. The decision on whether to incorporate or not is a commercial decision and should not be solely tax driven. However, there are a number of tax implications that may influence the decision.

If a business owner decides that he wants to cease operating as a sole trader and set up a company he needs to look at the timing of incorporation and the impact on his business structure. The main tax issues which should be reviewed when considering incorporation are set out below.

Tax Rates

The corporation tax rate on trading income is 12.5%. Passive income such as rental income is taxed at 25% in a company. The top rate of personal income tax is 55% (income tax at 40%, PRSI at 4% and USC at 11%) so there can be a tax rate difference of up to 42.5% between a company's tax liability on Irish trading income and that of a sole trader or partner.

The personal circumstances of the shareholders and their long term financial strategy will be relevant. If the taxpayer needs to take cash from the company in the form of salary to fund day to day living expenses there will be a corporation tax deduction for the company and the taxpayer will pay income tax on the salary, so there will be no profit in the company to take advantage of the favourable corporation tax rate. However, if the taxpayer does not need to use the business profits for day to day expenses then profits can be stockpiled in the company subject to favourable corporation tax rates.

Investment companies are generally subject to a tax surcharge of 20% (known as the close company surcharge) on undistributed investment income of the company (as adjusted for the surcharge) if the company decides to retain this income in the company. In order to avoid or minimise the surcharge, the company has up to 18 months after the accounting period ends to declare and pay a dividend. Other forms of distributions must be made before the accounting period ends to be taken into account as distributions.

A close company providing professional services has a surcharge of 15% on 50% of the retained professional services trade profits (as adjusted for the surcharge). As for the 20% surcharge above, the company has up to 18 months after the accounting period ends to declare and pay a dividend, while other forms of distributions must be made before the accounting period ends to be taken into account as distributions.

These sections are designed to prevent taxpayers avoiding tax by arranging for income which would be taxed at higher income tax rates to be diverted into companies and taxed at a lower rate. The surcharges reduce the differential between corporation tax rates and income tax rates.

Additional tax (Capital Gains Tax or income tax) will normally arise on the extraction of money from the company by the shareholders, so there will be an additional tax charge on cash extraction (see below).

Taxpayers should also consider the fact that loss relief for sole traders is not as extensive as that for companies. For example companies can set trading losses back against profits of previous periods whereas a sole trader cannot. If a sole trader or partner makes a profit in one period and makes a loss in the following period, there is no mechanism for setting the loss back against the profits of prior years. However an incorporated business in the same circumstances could generate tax refunds by setting the losses back against profits in earlier years.

Accessing Cash

Profits retained by a company and income generated from investments are "locked" into the company. There is a tax cost to extracting cash from a company. There are three classic ways of extracting cash from a company, i.e. by paying salary or bonuses, by declaring dividends (or by making other distributions) and by liquidating the company.

Salaries are subject to income tax and PRSI (including employer's PRSI) through the PAYE system. Any salary payments are tax deductible for the company.

Distributions to shareholders are subject to income tax and PRSI for the shareholders (although not employer's PRSI). Distributions are not tax deductible for the company.

The liquidation of a company allows the shareholders to access cash held at capital gains tax (CGT) rates which are generally lower than income tax rates. However any capital asset held by the company at the date of liquidation will also be disposed of, which may give rise to a charge to CGT for the company. There may be a second charge to CGT for the shareholder on disposal of the shares in the liquidated company.

It should be noted that funds can be retained in the company as working capital (but may be liable to the surcharges outlined above), or can be commuted into a pension, rather than being extracted by the shareholder.

Administration

There are costs to setting up and running a company over and above the costs associated with running a business as a sole trade or partnership. For example, a company has an obligation to file accounts (in many cases audited accounts are required) and to file corporation tax returns. There are also company law requirements such as the requirement to file CRO returns and hold directors' meetings.

If salary is drawn from the company it should register for PAYE/PRSI. If an individual was operating as a sole trader he would not have had this obligation unless he employed other individuals. Registration for PAYE also involves filing P30 returns for PAYE on a monthly or quarterly basis. This may have cash flow implications as tax must be paid monthly, or quarterly, under the PAYE system rather than on 31 October annually.

Employees & Family Members

It is possible to incentivise employees by passing on or selling part of a company to them, using different shares or different classes of shares. This cannot be done as a sole trader or partnership. A corporate structure can also facilitate inheritance planning.

Pensions

A company pension scheme is usually more efficient than an individual's personal pension plan, making it more attractive for employees to work in a company as opposed to for a sole trader or partnership. Employer pension contributions are attractive as they are not taxed as a BIK, and an employer can make up any shortfall in funding as the personal contribution limits do not apply. A sole trader is restricted in the level of contributions he can make to a pension.

Limited Liability

One of the most fundamental differences between a company and a sole trader is that a sole trader has unlimited liability. Therefore all assets (including all personal assets unrelated to the business) are on the line if a claim is made against an individual resulting from activity of the business.

The company is a separate entity to the individual shareholders and directors of the company. The shareholders cannot generally be pursued for company debt and are not liable for anything beyond the amount of capital contributed to the company, unless the corporate veil is lifted by a Court. There are penalties under company law for directors of a company who have been found to be trading recklessly or negligently, but there is no access to the non-company assets of such individuals.

The benefit of limited liability may be diluted by the provision of personal guarantees by company directors and shareholders.

Transfer of Business Assets into Company

There are some tax issues to be considered when transferring assets held by a sole trade or partnership into a company. The transfer of any chargeable assets from an individual to a company would generally attract CGT on any capital gain. However CGT relief may be given on the transfer of a business to a company. If the relief applies, the company is deemed to acquire business assets at the price which the individual transferring the assets originally acquired them.

It may also be possible to minimise stamp duty on the transfer of business assets to a company by passing by delivery as opposed to transferring by deed.

Investment/Future sale

If a businessman ultimately wants to attract third party investment, or sell his business once it is established, he will need to consider which structure suits his strategy. A company may be more attractive to investors (due to limited liability) and will offer more flexibility in structuring various classes of rights. If the ultimate aim is to sell the business a company may add an additional level of tax if the purchaser wants to buy the trade and not the company (which may carry hidden liabilities). If a company sells a business and pays CGT, the shareholder may have a second charge to tax on the extraction of the proceeds of sale. However, it may be possible to carry out a re-organisation to "package" a business for sale in a new company, and avoid any issues a purchaser may have on the tax history of the existing company.

Conclusion

The main issues which should be considered when deciding on whether to incorporate a business, or to trade as a sole trader or partnership, are outlined above. This is primarily a commercial decision, geared to each businessman's individual circumstances, and taxation issues are one factor that may influence the decision.

If tax advice is required on any point covered in this article an email should be sent to info@ohanlontax.ie.

Caveat: *These notes are intended as a general guide. OHT has endeavoured to provide an accurate commentary but the notes cannot cover all circumstances. OHT strongly recommends that formal tax advice be obtained before any steps are taken that may have a tax effect.*

O'Hanlon Tax Limited
6 City Gate, Lower Bridge St., Dublin 8
T: 01 6040280 F: 01 6040281 E: info@ohanlontax.ie W: www.ohanlontax.ie