Leitrim Business Network September 2014

Oifig Fiontair Áitiúil ***Liatroim***

Local Enterprise Office ***Leitrim***

Sole trader V's Limited Company

Presented by: Terry Casey FCCA

Casey Accountants Ltd

4 Townspark Centre, Carrick on Shannon

Tel: 0719621622 *(E) terry@caseyaccountants.ie*

www.caseyaccountants.ie

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1. <u>**Business Growth**</u>

- Your decision to transfer a business to a company should be based on sound commercial reasons, not short-term tax savings.

- **The Critical Issues are;**

- **(A)** ***How much is your business going to grow?*** If your turnover is going to grow from zero to €800,000 in 12 months (with profits of say €300,000), and continue growing rapidly, then it makes sense to have the profits taxed at the rate of Corporation Tax (12.5%). If the business is fairly stagnant (turnover of €50,000 with little growth), it makes sense to leave it as a sole trader business.

- **(B)** ***Use of Losses?*** Would you be better off using initial losses against your personal (sole trade) income, rather than have initial losses carried forward for relief against future profits of the company? This decision needs to be balanced against the protection of limited liability.

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- (C) *Do you intend to leave profits in the company, or pay them out regularly in the form of salary or dividends?*
- If you intend to extract all of the profits, then those profits are taxed at up to 41% in the hands of the shareholders unless the shareholders (or a majority of them) are non- resident, in which case they will pay tax on the dividend in their home country. If you do not intend to extract all of the profits, the company can be used as a savings box to build up funds for new business ventures. Such retained profits are not liable to surcharge as in the case of retained investment, rental and service company income.

2. <u>Level of Drawings</u>

- Transferring a business to a company can save cash flow if your drawings are significantly less than the company's profits- in other words, if the profits are allowed to build up in the company. E.G.

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- **Example**

You are a self-employed trader, your spouse does not have income in his/her own right.

You have traded for many years, generally earning €50,000 to €70,000 per annum which has been sufficient for your needs.

You have now been given an opportunity to earn €300,000 (€150,000 per annum for two years) by way of a contract.

You still need €50,000 a year to pay your private expenses, mortgage etc…

Should you continue as a sole trader or should you form a company?

If you earn €150,000 as a sole trader, you will suffer:

1. Tax of: (€41,800*20%) + (€108,200*41%)= €52,722. After deducting your personal tax credit (€3,300), this is reduced to €49,422.
2. PRSI of (€150,000)* 4% = €6,000
3. Universal Social Charge of: (€10,036* 2%) + (€5,980* 4%)+ (€83,984* 7%) + (€50,000* 10%) = €11,319

Total Charge: €49,422 + €6,000 + €11,319 = €66,741 (Effective Rate of 45%)

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If you earn €150,000 as through a company, and take a €50,000 salary, you will suffer:

1. Tax of: (€41,800* 20%)+ (€8,200* 41%) = €11,722. After deducting your personal Tax Credit (€3,300), this is reduced to €8,422.
2. PRSI of (€50,000)* 4%= €2,000
3. Universal Social Charge of : (€10,036* 2%)+ (€5,980*4%) + (€33,984* 7%)= €2,818

Income Taxes Charge: €8,422+ €2,000+ €2,818= €13,240

Added to this: Corporation Tax on profits of €100,000 (€150,000 less salary of €50,000)= €12,500

Total charge: €25,740 (Effective Rate 17%)

As a result of these steps, €100,000 has not been subjected to income tax, PRSI and USC. It has been subjected to Corporation Tax (€12,500) leaving €87,500 in the company.

But is the money not "stuck" in the company? Yes.

Would you rather have €87,500 "stuck" in the company (which will be subject to income tax etc if you take it out), or would you rather have €36,499 in your hand (after tax)?

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- **<u>Useful Tips</u>**

1. Don’t invest money into a company as share capital and then use the same money to pay yourself a salary which will suffer tax. Instead, lend the money to the company and take it back as a loan repayment.

2. If lending to a company, ensure the debt carries conversion rights so that It becomes an allowable loss if it becomes irrecoverable.

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- **Advantages of Incorporation**

The main advantages of carrying on your business through a company are:

(a) **Lower Tax Rates.** The general corporation tax rate is 12.5% . This compares with a marginal income tax rate of 41%, PRSI of 4% and universal social charge of up to 10% depending on the income. A company does not pay PRSI or USC on its profits.

A new start- up company (subject to conditions) can get a three year exemption which effectively reduces its annual tax charge of up to €40,000, to nil.

(b) **Pension Funding.** A company can get a deduction for contributions made to your pension scheme.

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(c) **Your company can employ your spouse and children.** Each can have their own tax allowances and PRSI limits. If €100,000 was earned by a company and split among four adult employees, the total tax bill would be lower than the income tax charged on one person with married rate bands.

(d) **Limited Liability.** In practice, this is not much of an advantage as bankers and key suppliers may require personal guarantees from the shareholders and/or directors in respect of company debts.

(e) **Group Losses.** A company which is part of a group can use a loss of a fellow group member against its own profits.

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- **Disadvantages of incorporation**

The main drawbacks of carrying on your business through a company are:

(a) **Double Charge.** This is also known as the profit- extraction problem. Your company pays tax on its profits (income and gains) and you, as shareholder, pay income tax on any dividend or income you take from the company. Therefore, you could end up paying tax at 41% on a gain on which the company has already paid tax.

(b) **Close Company Surcharge.**

- Undistributed rental and investment income of a close company is liable to a 20% surcharge.
- Undistributed income of a service company is liable to a 15% surcharge (on half the undistributed trading/professional income).

The surcharge, if paid, is wasted money, as you cannot even credit it against income tax liability when the income is distributed.

Strict Schedule E expense rules. A company director has fewer expense deductions than a self- employed person.

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(D) **Benefit In Kind.** This may be treated as a distribution of profits liable to a dividend withholding tax (DWT)

(E) **Excessive Interest.** This can be treated as a distribution liable to DWT.

(F) **Cost Of Incorporation and Annual Audit and Filing Fees.** This can run into thousands of euro. There is also the time and cost of taking minutes of directors' meetings, and loss of confidentiality. You must file your company accounts with the Companies Office where they can be inspected by anyone.

A 'small Company', need only file an abridged balance sheet. A company is 'small' if it meets any two of the following conditions:

(i) Turnover does not exceed €8.8m,

(ii) Balance Sheet total does not exceed €4.4m, and

(iii)The number of employees does not exceed 50

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- **Cessation of Sole trade**

If your sole trade business has completely ceased, your profits for the final tax year and the penultimate tax year of trading are revised to actual. This may give rise to additional income tax liability for you.

You may not carry forward sole trade losses into the company. It may be possible to claim terminal loss relief, and use the loss in the final year against income of the three preceding tax years. If there is no such income (the sole trade has always lost money), but there is a prospect of profits in the near future, it may be better to wait until the sole trade makes a profit and to use up the losses carried forward before incorporating. Otherwise, the tax value of the losses will be wasted.

If you transfer stock of your ceased sole trade to your company, you must value such stock at sale price or transfer consideration. This allows you to transfer such stock at book value.

The sole trader and its successor company may jointly elect that no balancing adjustment will be made on plant and machinery transferred. The plant and machinery will transfer to the company at their tax written down values.

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Capital Gains Tax On Transferring your Business to a Company

If you are aged 55 or over, you can claim retirement relief even though you are continuing to run the business through the company. Provided you fulfil the 10 year ownership requirement, and the transfer is for bona fide commercial reasons (the desire for limited liability presumably meets this test), you can transfer assets to a value of €750,000 to the company without giving rise to any CGT liability. If you are too young to claim retirement relief, or you do not meet the 10 year test, you can claim a deferral of any CGT liability arising on transfer of your business to the company. In effect, the value of the company shares will be depressed for CGT purposes, so that when you come to sell the shares, the in- built gain will crystallise.

Traps

1. **To claim retirement relief, you do not need to transfer the entire business to the company.**
2. **To claim the CGT deferral, you must transfer the entire business to the company.**

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- **Putting Property in a Company**

The advantages of holding property through a company are:

(a) Faster pay- down of debt. In a trading company, after paying 12.5% tax, 87.5% of profits are available to pay down debt. This may be an attractive option where the property is to be sold with the business, for example, in the case of a pub.

(b) Group Relief can shelter rents.

(c) Stamp duty on disposal of shares (1%) is lower than stamp duty on transfer of property (1-2%). This may enable the owner to command a slightly higher price on the sale of the shares in the company.

(d) 25% tax on rent is not excessive if the company is non- close, or if profits are being paid to a non- resident parent.

(e) The company can be made to buy un-saleable units (at market value) thus enabling the owner to extract profits.

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- <u>**Extracting Profits From a Company**</u>

1. **Income or Capital?**

In most cases, you will be caught for income tax at 41% on income you extract from your company. If this is taken as given, then it becomes more attractive to extract income in a form that can easily be sheltered. Another option is to extract capital, through an approved share buy- back, or complete liquidation of the company. Unless combined with retirement relief, such a capital extraction will be taxed at 33%.

2. **Rent**

You can extract profits by renting a premises to the company. If the rent is at a commercial level, your company gets a tax deduction, and you are taxed on the rent. You can shelter the rent with interest or tax incentive property.

Example

You charge your company €12,000 per year rent.

You pay €10,000 per year interest on the loan used to buy the premises.

You pay income tax on €2,000 (not €12,000)

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3. **Loan to Company**

You can lend money to the company instead of investing in shares. The company can then repay the loan without tax implications. You can also charge commercial interest on the loan.

Example

You lend your company €100,000 and charge 6% (APR) interest, payable on reducing balance.

The loan is repayable in full in 11 months' time.

After one month, you need some money back from the company, so the company repays €20,000.

There are no tax implications.

Traps

(a) **If the loan period is longer than one year, the company must withhold standard rate income tax from the interest payment and remit that income tax to Revenue. You get a credit for the 20% tax withheld against your (41%) tax liability.**

(b) **Excessive Interest is treated as a distribution and is subject to dividend withholding Tax.**

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4. **Salary**

As a director or employee, you can take a salary from your company.

As owner-director, you pay class S (self-employed) PRSI at a flat rate of 4%, plus USC at up to 7%.

As an wner-director, you must file a self- assessment tax return before the return filing date. Unless you have substantial non- PAYE income, you should not need to make a preliminary tax payment, as the PAYE deducted will cover your liability.

As a non-owner director, you will generally pay class A (employee) PRSI at 4% plus universal social charge at up to 10%. Your company will also pay employer's PRSI at 10.75% on earnings above €356 per week, or 8.50% on earnings below €356 per week.

Your company must also deduct PAYE and PRSI from your salary and pay the amounts deducted each month to the Collector- General. The salary is tax-deductible to the company.

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5. **Benefit In Kind**

You can give yourself a company car and other benefits, and these are generally taxable. Not taxable are: free bus/train tickets, subsidised on- premises crèche facilities, travel and subsistence expenses paid in line with civil service limits, employer's contribution to the employee's pension scheme.

6. **Dividends**

You can pay yourself a dividend from the company. However, unlike salary, a dividend is <u>not</u> tax- deductible to the paying company. It is a payment from after-tax profits to the company's shareholders.

A Company is legally restricted from paying a dividend if it does not have sufficient distributable reserves.

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7. Loan From Company

If your "close" company makes a loan to you as participator, it must withhold income tax from the amount of the loan and pay that income tax to Revenue.

If your company writes off the loan, you are treated as receiving, at the date of the write-off, income equal to the amount written off, grossed up at the standard rate of income tax. The company must pay the income tax to the Collector General.

Tip

A loan to a Full-time director or employee is not caught if the total amount lent is less than €19,050 and the person does not have a material interest in the company, i.e., is not able to control more than 5% of the company's share capital.

Trap

a) **There are no tax advantages in taking a loan from your company. Penalties for not paying income tax deductible can be severe.**
b) **A loan includes any form of credit.**

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8. **Approved share buy-back**

Your trading company can buy back your shares in order to benefit the company's trade, on doing so, the payment for the shares is treated as capital in your hands. (subject to conditions)

9. **Winding up**

If your company permanently ceases business and is (voluntarily) wound up, each shareholder receives a repayment of his/her capital investment. Any growth in that investment is taxed in the hands of the shareholder at the capital gains rate of 33%.

- **Thank You For Your Time**

- **Any Questions?**