Incorporation of an Audit Practice

Following amendments to Irish company law last year, Barry Moloney and Aidan Fahy discuss some of the key issues that should be considered when deciding whether to incorporate and take advantage of the benefits of incorporation.

Incorporating Your Audit Practice

Pursuant to the Statutory Audit Directive (S.I. No. 220/2010), which was signed into law on 20 May 2010, section 187 of the Companies Act 1990 has been amended, meaning auditors of companies can now incorporate. Now is an opportune time for statutory auditors to consider incorporation to avail of the benefits of separate legal personality and limited liability as well as certain tax advantages. The changes apply to “statutory auditors” and “statutory audit firms”. “Public auditors” are not captured by the changes but are still subject to the provisions of the Companies Act 1990. The issue of limiting the liability of auditors is currently under review at a European Commission level and it appears likely that there may be further uniformity of rules introduced on this matter.

The Primary Benefit of Incorporation as a Limited Liability Company

It is a well established principle of Irish company law that a company is an entirely distinct and separate legal person from its shareholders. Accordingly, it is only the company (as a separate legal person) which is liable for its debts and obligations. A benefit for an auditor, who incorporates as a limited liability company, is that the liability of the shareholders in respect of the debts and obligations of that company is limited to the amount, if any, remaining unpaid on the shares held by them, save in exceptional circumstances.

Prohibition on Limiting Liability Contractually

Auditors in Ireland are effectively prevented under statute from contractually limiting their liability to the companies they audit. Section 200 of the Companies Act 1963 renders void any provision (in a contract or otherwise) which purports to limit any liability of an auditor in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company.

Section 200(1)(b) of the Companies Act 1963 provides that a company may indemnify an auditor of the company against any liability incurred by him in defending proceedings, whether civil or criminal, in which judgment is given in his favour or in which he is acquitted. Accordingly, the indemnity will not apply if the auditor has been found guilty of negligence, for example.

If an auditor chooses to incorporate as a private limited liability company, the provisions of section 200 will still apply, such that the audit company is prevented from contractually limiting its liability to the companies it audits. Thus, for example, should the audit be carried out negligently, it is the audit company, as opposed to the auditor individually (or as a firm) that will be liable to the company that it audits. The audit company will be liable, up to the extent of its assets, including in respect of insurance cover that the audit company has. Should the assets of the audit company be insufficient to pay the damages arising, then the audit company would be insolvent. However, the shareholders of the audit company should not have any liability for the debts and obligations of the audit company (beyond their paid up share capital) and accordingly, there should not be recourse to the shareholders’ personal assets, in the event that the assets of the audit company are insufficient to pay the damages arising.

Transfer of Undertaking

In order to transfer the audit business to a newly incorporated company, a business transfer agreement should be put in place. This in turn may require the novation or assignment of a number of existing contracts to which the audit firm is currently party. Such a transfer of
the business is also likely to trigger the European Communities (Protection of Employees on Transfer of Undertakings) Regulations 2003, which (broadly speaking) entitles the employees of that business to transfer to the company on the same terms and with their continuity of service intact.

Administrative & Filing Requirements

Some additional compliance and filing requirements apply to a company, which do not apply to a partnership. For example:

- maintenance of capital provisions (under Irish company law), which restrict the movement of capital out of a limited liability company;
- the requirement to keep proper books of account which give a true and fair view of the state of affairs of the company;
- the requirement to present accounts annually to shareholders at the AGM; and
- the requirement to file an annual return in the Companies Registration Office.

If there is a concern in relation to the public availability of company’s accounts, it is possible to implement a structure such that the audit company would not have to file its accounts, whilst maintaining the protection of limited liability.

Shareholders’ Agreement

A shareholders’ agreement should be put in place in advance of the business and asset transfer. The shareholders’ agreement will essentially replace the partnership deed (to the extent that there is any in place) in regulating the relationship between the shareholders, in addition to capturing various elements which are company specific such as board composition and administrative issues, financing, confidentiality and shareholder rights and obligations.

Other Considerations

- Various regulatory requirements (for example registration with the CPA and minimum percentage voting rights in the company required to be held by statutory auditors) will also need to be complied with in the incorporation process.
- Future audits will be conducted by a new legal entity, therefore the audit firm will need to resign as auditor in compliance with the Companies Acts and IAASA notification requirements. The company will need to be appointed as auditor and a new engagement letter should be put in place.
- Professional Indemnity Insurance will need to be obtained in the name of the company.
- Where firms have already incorporated part of their practices, the ability to incorporate the audit function should simplify operational arrangements and lead to cost savings.
- Depending on the existing structure of the firm, a valuation of the audit practice may be required prior to the transfer of the business to the new company.

Continued on Page 42
IN PRACTICE
Incorporation of an Audit Practice

Tax Implications of Incorporation

Both the tax implications of incorporating and the tax implications following incorporation should be given due consideration prior to proceeding with the incorporation of an audit business.

The taxes which may arise on incorporation include capital gains tax, income tax, stamp duty and VAT. There are some reliefs and exemptions in respect of these tax heads and with appropriate planning it is possible to minimise any potential tax costs arising.

The timing of incorporation will be important because it will bring into operation the “cessation of trade” rules applicable to sole traders and partnerships. Where a partnership transfers a business into a limited company, the partners will be deemed to have ceased trading for income tax purposes. For a year of assessment, in which the trade ceases the assessment to tax will be on the profits of the period from 1 January to the date of cessation. The cessation rules provide that the profits of the penultimate year of trading may be reassessed to the profits arising in the actual tax year (ie the calendar year) as opposed to the 12 months up to which the partnership prepared their accounts, if this amount would be greater.

Following incorporation, corporation tax at the rate of 12.5% should apply to the profits derived from the professional services provided by the company. A higher corporation tax rate of 25% applies to passive income such as rental income and deposit interest. These rates compare favorably with the marginal rate of income tax.

When the shareholders wish to extract the profits from the company additional tax becomes payable. There are a number of ways in which cash may be extracted from a company, eg by way of salary and bonus or through the payment of a dividend. The use of pension contributions may be a tax efficient way to part remunerate employees and directors.

In many cases the new company will be regarded as a close company for tax purposes. A close company is one which is under the control of five or fewer persons. There are certain tax implications for close companies to consider, the impact of which may be mitigated with appropriate planning.

The deadlines for payment of income tax are different to those applicable to the payment of corporation tax. This may have cash flow implications for the business which will need to be considered.

The PRSI position for shareholders of the new company will need to be carefully considered, particularly where there is to be a large number of shareholders in the new company.

Conclusion

Incorporation of audit practices is a welcome change which has commercial and tax benefits. Now is an appropriate time for audit firms to consider incorporation but it is important to consider in advance the legal, regulatory and tax aspects which will impact the sole trader or partnership.

This article is not intended to be comprehensive or definitive, but, instead, to give you a flavour of some of the legal and tax issues arising in determining whether or not to incorporate. This article cannot be relied upon as professional advice and it is recommended that appropriate professional advice be obtained before proceeding.

For further information visit www.mop.ie.

Note for CPA Statutory Audit Firms

CPA statutory audit firms considering the incorporation of their audit firms should contact the Professional Standards Department of the Institute on 01-4251042 to ensure that the proposed new structure meets the requirements of the Practice and Audit Regulations. The CPA Audit Resource on the CPA website contains an information leaflet on the topic which may be of assistance, www.cpaireland.ie.