Tax Considerations for a Start Up Business that Advisors need to focus on

Mairéad Hennessy outlines some of the key tax considerations for a Start Up.

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For entrepreneurs setting up a business, there are a myriad of matters to consider in addition to running their core business. As trusted advisors, it is essential that accountants ask the right questions to get the necessary "snap shot" understanding of where the business is at and where its ambitions lie.

One of the most important tax decisions that can be made in relation to a new business is whether it should be carried on as a sole trade or a company. Here we look at some of the most common tax considerations that arise in the context of determining whether a new business venture be carried on through a company or as a sole trade.

Benefits of a company structure

- **Lower tax rates** - Ireland's 12.5% tax rate applies to the trading profits of most types of companies. By contrast, individuals may pay tax on up to 55% of their trading profits. The business owner can dictate the amount of salary to extract from the company and thus retain a level of control over the income tax liability ultimately suffered by way of PAYE, PRSI and Universal Social Charge. This is different to the position of a sole trader who must pay income tax on the total business profits irrespective of whether or not they are taken out of the business.

- **Business financing -** When an initial cash investment is required by the business, the business owner may lend the funds to the company through which the business is operating by way of a "director's loan". Such a loan can be repaid to the business owner tax-free by the company as cash becomes available. This assumes that the business owner becomes a director of the company on incorporation. If this approach is being considered, advisors should be aware that if the company will have preferential shareholders, for example Enterprise Ireland, then such preferential shareholdings may take priority in repayment to the director's loan.

- **Borrowing from financial institutions** - It is more tax efficient to borrow money through a company than through a sole trade business. The company tax rate of 12.5% leaves 87.5 cent in every euro of trading profits retained in the company for development/loan repayments compared with as little as 45 cent when trading as a sole trader taxed at the marginal rate of income tax. Thus, it is tax efficient to operate through a company where there is an intention to build up profits in the company for future business expansion.

- **Pension contributions** – Pension contributions remain one of the most tax efficient methods of extracting funds from a company and the company gets a tax deduction for the pension contribution made. The tax treatment afforded to company pension plans is more generous compared with self-employed pension plans.

- **Greater number of tax reliefs available to companies -** There is a broader range of tax reliefs available to companies than to sole trades. Valuable tax reliefs available to new companies include:

  - <u>Start Up Corporation Tax Exemption</u> - This relief reduces corporation tax on the profits of a new trade and gains on disposal of any assets used for the purposes of the new qualifying trade by the amount of PRSI paid for each employee, subject to a maximum of €5,000 per employee and an overall limit of €40,000 in the first 3 years of trading.

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- Enterprise and Investment Incentive Scheme - This incentive provides tax relief to investors of certain companies. A company can obtain large scale investment in a tax efficient manner over a period of 5 years provided certain conditions are satisfied. This scheme allows individual investors to obtain income tax reliefs of up to €150,000 per annum on investments in certain qualifying companies.

- Start Up Refund for Entrepreneurs - This scheme allows an individual leaving employment to set up their own business to reclaim income tax on the capital invested in the new business. The capital must be invested as shares in the company. The income tax refund can be claimed in respect of up to €600,000 of income in the previous 6 years, subject to an annual income cap of €100,000 in each of the six years. Under this scheme, if an employee leaves employment and invests in shares in a company, which carries on new business, he/she may claim a refund of income tax paid in the previous 6 years, known as seed capital relief.

- R&D tax credit – For every €100 of qualifying research and development expenditure identified as eligible R&D spend, a company could be entitled to €25 in tax credits in addition to the 12.5% corporation tax deduction on the expenditure incurred. This credit can be offset against tax liabilities arising or provide cash refunds where certain conditions are met. It may also be used as a means of incentivising key R&D staff.

- Knowledge Development Box - This relief provides that profits from patented inventions and copyrighted software earned by a qualifying Irish company can, to the extent that it relates to R&D undertaken by that company, be effectively taxed at a rate of 6.25%.

- **Termination payments** - Company directors are entitled to a lump sum tax free payment for loss of office on retirement. This tax treatment does not apply to sole trade business owners.

- **Limited liability** – In a litigious environment, there are benefits in having limited liability. However, entrepreneurs should be aware that frequently banks and key suppliers may require personal guarantees from the shareholders and/or directors in respect of company debts thus eroding the benefit of limited liability. Nevertheless operating through a company can increase the credibility of a business with third parties.

Benefits of a sole trade structure

There are however times when it can be beneficial to operate the business through a sole trade, for example:

- **Trading losses** - If trading losses are expected in the first few years of business then it might be best to operate the business as a sole trade for this period. This decision will require consideration of the business owner(s) marginal rate of tax for income tax purposes and the extent to which the amount of the Case I or II losses will be absorbed by their other sources of income.

- **Double charge to tax –** The company pays tax on its profits and in addition, income tax is payable by business owners on any income or dividend extracted from the company. However the aggregate tax paid by the company and business owner should be less than would be paid where the business is operated as a sole trade, otherwise incorporation would generally not be advisable from a tax perspective.

- **Start Your Own Business Relief –** This relief applies to individuals who were unemployed for at least 12 months before setting up the business and in receipt of certain social welfare payments. It provides an exemption from income tax on up to €40,000 of their qualifying profits from that business for the first two years of trading. It applies only to sole traders and not incorporated businesses.

- **Succession Planning** – If the business owner has grown up children and would like to pass the business to them over time, the transfer of an incorporated business to the next generation is more complex than if the business is being carried on as a sole trade. However, with careful planning the various tax reliefs should not be lost for an incorporated enterprise.

- **Close company surcharge** – The vast majority of Irish small companies are subject to the "close company rules" which stipulate that 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 of the undistributed trading/professional income).

Ample time and careful consideration should be given by business owners and their advisors as to what is the optimum structure for the business from the outset.