8-2013

Work out optimum tax rates, benefits for a new business

Teng Aun Khoo
Singapore Management University, takhoo@smu.edu.sg

Clement Tan Kai Guan

Follow this and additional works at: http://ink.library.smu.edu.sg/soa_research

Part of the Accounting Commons

Citation
Research Collection School Of Accountancy.
Available at: http://ink.library.smu.edu.sg/soa_research/1106

This News Article is brought to you for free and open access by the School of Accountancy at Institutional Knowledge at Singapore Management University. It has been accepted for inclusion in Research Collection School Of Accountancy by an authorized administrator of Institutional Knowledge at Singapore Management University. For more information, please email libIR@smu.edu.sg.
Work out optimum tax rates, benefits for a new business

By Clement Tan Kai Guan and Kho Teng Aun

Among the initial considerations that an entrepreneur has to decide when starting a new business is the form of his or her business vehicle. Besides limiting its liability, another important factor is tax in deciding on the form of the business vehicle. It is not uncommon for businesses to be carried out either as a sole proprietorship (SP) or as a one-shareholder company.

The income of an SP is taxed in the hands of a sole proprietor in his individual capacity based on progressive tax rates of up to 20 per cent maximum whereas the income of a company is subject to the prevailing corporate tax rate of 17 per cent.

For a company which qualifies under the start-up tax exemption (SUITE) scheme, the first $100,000 of its normal chargeable income (CI) qualifies for full exemption and the next $200,000 of its normal CI qualifies for 50 per cent exemption, giving a maximum tax exemption of $300,000.

Hence for the first $100,000 of the company’s normal CI which is fully tax exempt, there will be no tax payable by a qualifying company. However if the business setup is that of an SP, the tax payable by a sole proprietor deriving a CI of $100,000 is $5,650. (ignoring personal relief).

Since 50 per cent of the next $200,000 normal CI is tax exempt, the corporate tax payable for a CI of $200,000 is $17,000. The effective tax rate is thus less than 17 per cent after taking into account the SUITE.

However, if this incremental income is taxed in the hands of a sole proprietor, it will attract an additional tax of $33,100, giving rise to a total tax of $38,750 for a $300,000 income level. Thus from a tax perspective, it is without doubt that corporatizing a business is better than setting it up as an SP vehicle.

So far, we have ignored any remuneration paid by the company as an employer to its sole shareholder as an employee. The following example will assume a total remuneration of $85,000 comprising a monthly salary of $5,000 and a five-month bonus payable by a company to its sole shareholder-employee. Based on this remuneration, the company is required to make a statutory Central Provident Fund (CPF) contribution of $13,600 in respect of its Singaporean Singapore Permanent Resident shareholder-employee and it can fully claim tax deduction for both salaries and employer’s CPF contribution of $90,600. The balance of income after tax can be paid as tax exempt dividends to the shareholder-employee. However, “salaries” drawn by a sole proprietor from his business are not tax deductible in determining his taxable income derived from the SP business.

Total CPF contribution in respect of the shareholder-employee is $30,600. The $17,000 CPF contribution by the shareholder-employee qualifies for personal relief whereas his employer's CPF contribution is tax exempt in his hands. If the sole proprietor voluntarily contributes his own CPF up to a maximum of $30,600, the entire sum qualifies for personal relief.

Ignoring any tax rebate and assuming a taxable income of $300,000 before remuneration, the company’s net tax payable is $8,619 for a net taxable income of $291,400.

As the remuneration received by the shareholder-employee is taxable in his hands, the tax payable for the shareholder-employee is $2,440 assuming an earned income relief of $1,000. Thus the overall tax liability for using the corporate vehicle is $11,059 which is much less than the sole proprietor’s net tax payable of $33,062 for the same level of taxable income.

In this case, tax payable from the perspective of an SP vehicle is approximately three times the total tax payable by the company and its shareholder-employee.

When the level of taxable income exceeds $300,000, it can be seen from the following graph that lower tax is payable from the perspective of a business that is set up as a corporate vehicle than that of an SP.

Conclusion

As cash flows are especially vital for small businesses in their initial stages, corporatizing a business would generally be more advantageous from a tax viewpoint than setting it up as an SP vehicle if the business is expected to be profitable in its initial years as it will be able to avail itself of the benefits under the SUITE scheme.

Otherwise, it would be better off to set up a business as an SP and incorporate it at a later date when it becomes profitable.

In addition, payment to the shareholder-employee in the form of salaries for services rendered can help to reduce the overall tax payable from both the shareholder-employee and the company perspective when compared with that of an SP business.

The writers are associate professors of accounting at NTU and SMU respectively.