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Corporatisation or Sole Proprietorship? Business Vehicles for New Businesses

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CORPORATISATION OR SOLE PROPRIETORSHIP?

Business Vehicles for New Businesses

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An important issue facing entrepreneurs starting new businesses is to decide on the form of business vehicle that should be employed. Most businesses carried out by individuals are commonly carried out either as a company where the owner is also an employee (owner-employee) or a sole proprietorship (SP). One of the considerations in addressing this issue would be the income tax implications of corporatising a business versus a sole proprietorship business.

Currently there is a difference of three percentage points between the prevailing corporate tax rate of 17% and the highest progressive personal tax rate of 20%. As the income of an SP is taxed in the hands of a sole proprietor in his individual capacity at graduated rates, tax-wise, it may appear that an SP is a better business vehicle than a company where the level of taxable income earned is subject to tax at the individual's marginal tax rate of below 17%.

For newly Singapore-incorporated companies which qualify for the start-up tax exemption (SUTE) scheme, the first \$100,000 of the normal chargeable income (CI) qualifies for full exemption and the next \$200,000 of the normal CI qualifies for 50% exemption, giving a maximum exemption of \$200,000. Therefore, 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. Since 50% of the next \$200,000 normal CI is tax exempt, the corporate tax payable for a CI of \$300,000 is only \$17,000. However if the business setup is that of an SP, the tax payable by a sole proprietor deriving a CI of \$100,000 and \$300,000 is \$5,650 and \$38,750 respectively (ignoring personal reliefs).

To qualify for the SUTE, the company has to be tax resident in Singapore and must not have more than 20 shareholders where at least one shareholder is an individual beneficially and directly holding at least 10% of the issued ordinary shares of the company.

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As the SUTE scheme is only applicable to a qualifying company for the first three consecutive YAs starting from incorporation, corporatising a business should be avoided unless it is expected to be profitable in its initial years.

TAPPING ON SUTE

Table 1 assumes

(a) A newly Singapore-incorporated company;
(b) A taxable income before salaries and employer's CPF to owner-employee of $300,000;
(c) A total remuneration of $85,000 comprising a monthly salary of $5,000 and a five-month bonus payable to the owner-employee, and
(d) An employer's statutory CPF contribution of $13,600 (that is, $85,000 x 16%) payable to the owner-employee.

TABLE 1 Illustration of SUTE

BUSINESS VEHICLE	COMPANY		SP
TAXABLE ENTITY	COMPANY	OWNER-EMPLOYEE	SOLE PROPRIETOR
Taxable income before salaries and Employer's CPF to owner-employee	300,000		300,000
Less: Salaries ($85,000) and Employer's CPF ($13,600)	(98,600)	85,000	
Assessable income	201,400	85,000	
Less			
Earned income relief	–	(1,000)	(1,000)
CPF relief	–	(17,000)	(30,600)
CI	201,400	67,000	268,400
Less: SUTE with first $100,000 exempt and the balance of $101,400 @ 50% exempt	150,700	N/A	N/A
CI after SUTE	50,700	67,000	268,400
Tax payable	8,619	2,440	33,062
Less: 30% CIT rebate/ Personal income tax rebate	(2,586)	(732)	(1,500)
Net tax payable	6,033	1,708	31,562
Total tax payable	$7,741		31,562

Salaries paid by an SP to a sole proprietor are not tax deductible in determining the taxable income derived from an SP, but a company can claim tax deduction for both salaries and employer's CPF contribution in respect of its Singaporean/Singapore Permanent Resident[1] owner-employee. Salaries received by the owner-employee are taxable at the graduated individual rates whereas the employer's statutory CPF contribution is tax exempt in his hands.

In Table 1, the total CPF contribution in respect of the owner-employee is $30,600 comprising:

(a) Employee's CPF contribution of $17,000 which qualifies for personal relief, and
(b) Employer's CPF contribution of $13,600.

If this total CPF contribution of $30,600 is voluntarily made by the sole proprietor, the entire amount qualifies for personal relief in this case.

After taking into account the remuneration paid to its owner-employee, the company's net tax payable is $6,033 and together with the tax of $1,708 payable by the owner-employee, the overall tax liability for using the corporate business vehicle is $7,741. If no remuneration was paid to the owner-employee, the company would have to pay $11,900 ($17,000 less 30% corporate tax rebate of $5,100) as compared with $7,741.

Nevertheless whether remuneration is paid or not, this is much less than the sole proprietor's net tax payable of $31,562 after taking into account the YA2013 personal income tax rebate of 30%, capped at $1,500.

As the SUTE scheme is only applicable to a qualifying company for the first three consecutive YAs starting from incorporation, corporatising a business should be avoided unless it is expected to be profitable in its initial

[1]Singapore Permanent Resident must fulfil at least two years to qualify for the full CPF contribution

years. Thus, if the business is expected to incur tax losses in its initial years, tax-wise, it would not be beneficial to corporatise the business from the outset as the SUTE is of no use for a loss-making situation. In such a situation, it would be better to start off the business initially as an SP and corporatise it at a later date when it becomes profitable.

TAPPING ON PTE

After the company's first three YAs, the partial tax exemption (PTE) scheme will apply henceforth. The PTE scheme provides a tax exemption of 75% for the first $10,000 of normal CI and 50% for the next $290,000 of normal CI, giving a maximum tax exemption of $152,500 for each YA. Applying the same assumptions above, the tax payable by a company qualifying for PTE versus a sole proprietor is shown in Table 2.

Ignoring the tax rebates, the total tax payable for the company and its owner-employee is $19,134 ($16,694 + $2,440) which is still lower than the $33,062 payable by the sole proprietor.

TABLE 2 ILLUSTRATION OF PTE

BUSINESS VEHICLE	COMPANY		SP
TAXABLE ENTITY	COMPANY	OWNER-EMPLOYEE	SOLE PROPRIETOR
Taxable income before salaries and Employer's CPF to owner-employee	300,000		300,000
Less: Salaries ($85,000) and Employer's CPF ($13,600)	(98,600)	85,000	
Assessable income	201,400	85,000	
Less			
Earned income relief	-	(1,000)	(1,000)
CPF relief	-	(17,000)	(30,600)
CI	201,400	67,000	268,400
Less: PTE with first $10,000, 75% exempt and the next $191,400, 50% exempt	(103,200)	N/A	N/A
CI after PTE	98,200	67,000	268,400
Tax payable	16,694	2,440	33,062
Total tax payable	$19,134		33,062

CONCLUSION

The decision whether to corporatise a business or not may have an impact on its overall tax cash flows. As cash flows are especially vital for small businesses in the initial stages, from a tax viewpoint, corporatising a business would generally be more advantageous than using 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 SUTE scheme (and in later years, the PTE scheme). In addition, payment of salaries for services rendered by the owner-employee can help to further reduce the overall tax payable by both the company and the owner-employee, which is not applicable to an SP. ISCA

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