

## FINANCE

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# Incorporation

In deciding whether or not it would be wise to incorporate a business, you will need to consider both commercial and taxation factors - assessing the advantages and disadvantages associated with operating through a company. Before a sole trader decides to incorporate, the actual tax implications of transferring a business into a company must also be considered. There are also implications for pharmacists either operating as locums or pharmacy owners employing locums.

## Does 'One Size Fit All' - Should all Pharmacists Incorporate their Businesses?

As a general rule of thumb, I advise sole traders to consider incorporating their businesses when the business begins to generate more taxable profits than is needed to support their lifestyle, i.e. where the personal drawings from the business are significantly less than the profits.

Purely from a tax perspective, business profits are only liable to tax at 12.5% in a company (or 25% for passive income, such as investment or rental income) as opposed to a sole trader, who is taxed at up to 41%, plus PRSI, plus income levies. Furthermore, Finance Act (No.2) 2008 introduced a three-year corporation tax exemption (subject to certain limits) for new companies (incorporated after 14 October 2008) commencing to trade in 2009 or 2010. Unfortunately this exemption does not apply to the incorporation of an existing trade or to a trade that would be considered a 'professional service'.

### Possible Advantages of Incorporation

There is no point in setting up your pharmacy as a company if there are no surplus taxable profits. Similarly, it does not make sense to incorporate a company while the business is loss making (as may often be the case for start-up businesses) as losses incurred by a sole trader may be offset directly against the sole trader's other taxable income, whereas losses incurred by a company are ring fenced within the company.

Assuming, however that your pharmacy business is generating surplus profits, operating your business through a company could offer the following advantages:

**Pension Planning** – Businesses are not profitable all of the time and, therefore owners/directors of companies - or the company itself - may not be in a position to make regular contributions to their pensions. Even in a relatively stable business, such as a pharmacy business, adverse or unexpected conditions (such as the recent issues concerning dispensation payments under certain State drug schemes) may occur in the market.

Pension legislation provides that companies may concentrate pension contributions to a director's occupational

pension over a shorter number of years than that which applies in the case of a sole trader. This allows a more practical funding arrangement whereby a company can pay into a director's occupational pension scheme when it can afford to do so. In the years in which the company is profitable, it can therefore make contributions to a director's occupational pension scheme (within certain funding limits), without the director incurring any tax liability.

As a company, you can set up a SSAP (small self-administered pension) for the company director(s) which has far greater flexibility than the typical personal pension option available to those who are self employed. Briefly, an SSAP can allow for multiples of salary to be invested in your pension, you can directly control where all your funds are placed and the choice of your investments and investment types are far greater than standard personal/group pension schemes. They are also highly tax-efficient – in general, contributions made by a company qualify for Corporation Tax relief, as do members' personal contributions.

I consider this a very important advantage to incorporation as quite often sole traders can neglect their pension planning.

**Succession Planning** – Generally, a company may be a more attractive business prospect than a business which is operated as a sole trade if considering passing it on to the next generation or selling to a potential purchaser in the future. Obviously, each situation will warrant its own considerations. Not only will the stamp duty cost be reduced (purchase of shares as opposed to property) but the pharmacy owner may be in a position to extract profits tax efficiently before the disposal, thus reducing the overall tax cost to both the seller and the purchaser. This can be achieved through the owner taking a tax free ex-gratia payment from the company on retirement or making additional pension contributions in advance of the sale. The pharmacy owner may also potentially avail of a relief known as “Retirement Relief”, assuming that the conditions necessary to claim this relief are met.

**Working Capital** – Building up a working capital fund in the company can allow the company (if it so desires) to expand (in the same or a different market) at a much faster rate. The net profit after tax in a trading company can be as high as 87.5% of the profit (i.e. profit after 12.5% corporation tax) whereas, in a personal capacity, the equivalent after tax profit could be as low as 46%. It is important to point out, however that if the surplus after tax profits are not used constructively by the company, and the owners / directors wish to extract such funds by way of dividend / salary, there may be an element of double taxation, i.e. initial tax paid by the company and further tax paid individually.

**Cash Extraction** – As mentioned above, all profits accruing to a sole trader are taxed in full each year at the marginal rate of income tax (currently 41%) plus PRSI, plus levies. By incorporating, cash may be accrued in the company and extracted at a later date, in the form of dividends, salaries etc, e.g. at a time when the recipient may be in a position to shelter that income from tax at the higher rates.

You can set your remuneration at a reasonable level to meet your living expenses, thus minimising income tax and retaining excess profits within the



business to act as working capital. If excess profits were to accumulate within the business, it may (depending on the circumstances) be possible to extract those funds by way of a capital distribution. The advantage of this is that a capital distribution attracts capital gains tax at 25%, as opposed to income tax at up to 41%, plus PRSI and levies.

**Locums** – The Revenue Commissioners are currently focusing on the area of locums in the field of pharmacy and are of the view that many locums who are operating as self employed persons are, in fact employees. Statements in the locum’s contract to the effect that they are ‘deemed to be an independent contractor’ or ‘are not an employee’, etc will not, in themselves be sufficient to prove self employed status.

The Revenue Commissioners will consider all the facts of the case in order to determine the actual substance of the contract. If the locum were to set up a company, through which they would provide the locum services, this issue of being an employee would not arise (under current legislation) as a company cannot be an employee of another company. If this route is chosen, the locum will be an employee of the company that they set

up and will need to consider the ‘close company’ issues I discuss below.

**Limited Liability** – Another valuable advantage is that a company is considered to be a separate legal entity distinct from its shareholders, which affords protection for personal assets. A person cannot generally be held personally liable for the debts of a company beyond the amount of capital that they have contributed to a company. It should be noted, however that this limited liability advantage may be diluted if, for example a bank required personal guarantees in relation to loans advanced to the business. Being a director of a company however does bring its own particular responsibilities and duties.

## Possible Disadvantages of Incorporation

Looking at the down-side in deciding to incorporate, a sole trader should also consider the following issues:

**Close Company Issues** – In general, if a company is owned by five or fewer persons it is called a ‘Close Company’. Close companies need to beware of accumulating investment or rental profits because a surcharge may apply to any of

## FINANCE



these profits that are not extracted from the company through salary or dividends. Furthermore, certain types of professional services profits are also subject to surcharge if left in a company. It is stated in Revenue Tax Briefing Issue 48 that the operation of a retail pharmacy is not considered to be a 'professional service' to which the surcharge will apply. However, it is possible that the provision of services as a locum pharmacist through a company could be regarded as a professional service, in which case a surcharge would apply.

**Tax Costs of Incorporation** – If correctly structured, it should be possible to minimise tax costs associated with incorporating a pharmacy business, as certain tax reliefs are available for this type of transaction. It is important that proper tax advice be sought because it is easy to inadvertently incur unnecessary tax charges if the transaction is not properly effected.

**Administration Costs** – There are higher administration costs involved in running a company. These include the requirement to file annual returns with the Companies Office and, in certain cases, to prepare audited accounts. These costs may outweigh the cash flow advantages if the surplus profit is not significant enough. The Companies Office returns also result in a certain loss of confidentiality.

The decision to incorporate should only be made after a thorough examination of all the advantages and disadvantages and a review of your individual circumstances and future plans.

I weigh up all the relevant factors with my pharmacy clients before advising them on the best structure for their business because there is no 'one size fits all' solution. The above points are general in nature and any pharmacist considering incorporating their business should ensure that they consult their accountant and tax advisor.

Setting up a new business as a company is a relatively straightforward process, while changing from a sole trade to a company is more complex. In either instance you need to ensure the transaction is both appropriate to your needs and, if so, is properly affected.

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