

Choosing the *right* Business Organisation:

Relevant Legal, Financial and Tax Considerations

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A. Legal Considerations – Choosing the Right Legal Business Structure

You may choose to register a business in the form of sole-proprietorship / partnership or incorporate a company. By and large, there are 4 relevant considerations when choosing a suitable business organisation:

- 1) Limited liability Status
- 2) Investment & Management Structure / Ease of Formation & Cessation
- 3) Tax Factor
- 4) Cost Factor

Businesses

Sole proprietors and partnerships are easy to form and dissolve as these not separate legal entities from the business owners. However, the business owners are exposed to unlimited liability when operating their businesses. The assets and liabilities of the business belong to the owners (not the business entity). Cost of registering a new business is \$65. The business needs to be renewed every year, at a fee of \$20. There is hardly any need to engage professional assistance in starting and running a business. However, larger businesses typically engage accountants to prepare their accounts and tax computations.

Companies

A company is a separate legal entity with formal investment / management structure comprising shareholders and board of directors. Such structure is the cornerstone for building large companies regardless of the numbers of shareholders. Companies are governed by the Companies Act. Compliance secretarial functions include the need to keep proper records such as directors' resolutions and shareholders' minutes, registers of members, officers, share allotments and transfers, charges etc. Company directors are legally obligated to ensure that accounts are properly kept, statutory returns properly and promptly filed. They must also exercise due diligence and act in the best interest for the company.

A company can have only one director and shareholder. Incorporation costs \$315. Filing of annual returns costs \$20. Given the need to comply with the Act, most small companies outsource secretarial functions to professional secretarial agents. Cost of such assistance typically ranges from \$300 to \$700 a year.

Under the Act, all companies (except small exempt private companies) must have their accounts audited every year. Small exempt private companies are private companies with less than 20 individual (non-corporate) shareholders with annual turnover not exceeding \$5 million. A good majority of small companies in Singapore are small exempt private companies. Still, they are required to present unaudited financial reports prepared in accordance with Financial Reporting Standards. Cost of preparing unaudited financial report and tax computation by professional firms ranges typically from \$400 to \$800. For those who want to have their accounts audited, audit fee typically starts from \$800 onwards, typically \$1,500 to \$2,500 for most small businesses.

LLPs

Limited liability partnership (LLP), a hybrid between partnership and company, is a new vehicle for those who want limited liability status but are not ready for the higher costs or formality of a private company. Under the LLP structure, the entity is a separate legal entity and enjoys limited liability status. There must be at least 2 partners but unlike partnerships, there is no limit on the number of partners. Assets and liabilities belong to the firm. For tax purposes, profits and drawings by partners are taxed individually. Cost of registering a LLP is \$165. The manager needs to file annual declaration of solvency, which costs \$10 per filing.

Concluding Remarks

Given a choice, most stakeholders, financiers, suppliers would prefer to deal with a company because it is a well-established, formally-structured and highly transparent business organizational structure, which if well capitalized, offer a credibility level unmatched by non-corporate entities.

However, jumping into corporate bandwagon without sound business planning, adequate funding, and due considerations of legal, tax and financial aspects can be onerous and costly. Each type of business organisation has different strengths and drawbacks. You will need to assess your own needs in order to make the right choice. If you are unsure, you can always register a business and convert it to a company when the time is ripe.

B. Financial Considerations – How Much Capital Contributions?

Only companies have paid-up share capital. Amount committed by shareholders as share capital cannot be withdrawn. Dividends can only be paid out of profits and revenue reserves. The minimum capital for a company is \$1 per shareholder. If the company has only 1 shareholder, then the minimum paid-up capital for the company is \$1.

The liability of the shareholder is limited only to the extent of her share contribution. The lower the share capital the lower is her liability. However, this has to be balanced with the need to show higher commitments to stakeholders, including financiers and suppliers. A company may need to have a certain level of share capitalization before certain government agencies or suppliers permit them to tender for projects or purchase of goods.

Regardless of the level of share capital, every business operation requires funds and working capital to finance its assets, including plant and equipment, stocks, trade receivables, deposits etc. The share capital is the part of shareholders' funds that has been capitalized. Whatever not capitalized was considered loans from the directors / shareholders, which may or may not be interest-free.

A simple illustration is as follows:

Mr A incorporated ABC Pte Ltd with a share capital of \$100 and opened a bank account, which requires a minimum of \$5,000. Mr A put in \$100,000 and subsequently paid for machinery, office rental and other expenses. In terms of accounting, the share capital of the company is \$100, with the remaining \$9,900 a loan from Mr A for working capital purposes.

C. Tax Considerations – To What Extent Can You Plan?

Anyone who derives an income has to pay tax – be it employer or employee. Always distinguish between whether receipts are recurring income nature (taxable) or capital gains (not taxable). Unlike employment income, business income offer more scope for tax planning by virtue of the variables involved.

For tax purposes, sole proprietors and business partners are considered self-employed, and business profits are taxed at individual rates (Nil to 21%).

Full tax exemption can be granted on normal chargeable income (excluding Singapore franked dividends) of an exempt private company up to \$100,000, for any of its first three consecutive Years of Assessments (YAs) that falls within YA 2005 to YA 2009. The first YA refers to the year of assessment relating to the basis period during which the company is incorporated. Any company that does not meet the qualifying conditions would still be eligible for partial tax exemption, which applies to all companies. Under the partial tax exemption scheme for companies, 75% of up to the first \$10,000 of a company's chargeable income are exempt; and 50% of up to the next \$90,000 of the company's chargeable income are exempt.

Many small company owners are also employees who draw salaries. In addition, they may draw annual directors' fees which are not subject to CPF contributions. Directors fees are only accrued to the directors when it is approved at the company's annual general meeting, Tax will be assessable on the individual directors in the year following the financial period which it relates to.

In practice, directors whom are also the same shareholders of closely-knitted companies typically draw directors' fees to minimize profits being tax at corporate rate – provided their individual tax rates are lower than the corporate tax rate of 20%. Such practice may not be improper as long as the amounts are not unreasonably excessive.

The comparative rates shown overleaf enable business owners to understand tax implications under individual and corporate rates.

Comparative Table: Individual vs Corporate Tax Rates

Year of Assessment 2006

| Chargeable Income (\$) | Individual tax rate (%) | Individual tax payable (\$) (a) | Company tax rate (%) | Company tax payable (\$) (b) | Difference in tax payable (\$) (b) - (a) |
|--|-------------------------------|--|----------------------------|---------------------------------------|---|
| \$10,000 to \$100,000 chargeable income bracket | | | | | |
| 10,000 | - | - | 5% | 500 | 500 |
| 20,000 | - | - | 7.50% | 1,500 | 1,500 |
| 30,000 | 1.25% | 375 | 8.33% | 2,500 | 2,125 |
| 40,000 | 2.38% | 950 | 8.75% | 3,500 | 2,550 |
| 50,000 | 3.65% | 1,825 | 9.00% | 4,500 | 2,675 |
| 60,000 | 4.50% | 2,700 | 9.17% | 5,500 | 2,800 |
| 70,000 | 5.11% | 3,575 | 9.29% | 6,500 | 2,925 |
| 80,000 | 5.56% | 4,450 | 9.38% | 7,500 | 3,050 |
| 90,000 | 6.56% | 5,900 | 9.44% | 8,500 | 2,600 |
| 100,000 | 7.35% | 7,350 | 9.50% | 9,500 | 2,150 |
| \$200,000 to \$1,000,000 chargeable income bracket | | | | | |
| 200,000 | 11.63% | 23,250 | 20.00% | 40,000 | 16,750 |
| 300,000 | 13.75% | 41,250 | 20.00% | 60,000 | 18,750 |
| 400,000 | 15.41% | 61,650 | 20.00% | 80,000 | 18,350 |
| 500,000 | 16.53% | 82,650 | 20.00% | 100,000 | 17,350 |
| 600,000 | 17.28% | 103,650 | 20.00% | 120,000 | 16,350 |
| 700,000 | 17.81% | 124,650 | 20.00% | 140,000 | 15,350 |
| 800,000 | 18.21% | 145,650 | 20.00% | 160,000 | 14,350 |
| 900,000 | 18.52% | 166,650 | 20.00% | 180,000 | 13,350 |
| 1,000,000 | 18.77% | 187,650 | 20.00% | 200,000 | 12,350 |
| \$2,000,000 to \$10,000,000 chargeable income bracket | | | | | |
| 2,000,000 | 19.88% | 397,650 | 20.00% | 400,000 | 2,350 |
| 3,000,000 | 20.26% | 607,650 | 20.00% | 600,000 | (7,650) |
| 4,000,000 | 20.44% | 817,650 | 20.00% | 800,000 | (27,650) |
| 5,000,000 | 20.55% | 1,027,650 | 20.00% | 1,000,000 | (27,650) |
| 6,000,000 | 20.63% | 1,237,650 | 20.00% | 1,200,000 | (37,650) |
| 7,000,000 | 20.68% | 1,447,650 | 20.00% | 1,400,000 | (47,650) |
| 8,000,000 | 20.72% | 1,657,650 | 20.00% | 1,600,000 | (57,650) |
| 9,000,000 | 20.75% | 1,867,650 | 20.00% | 1,800,000 | (67,650) |
| 10,000,000 | 20.78% | 2,077,650 | 20.00% | 2,000,000 | (77,650) |

Tax savings scenario for qualifying new companies for first 3 consecutive years between YA2005 and YA2009 vis-à-vis normal corporate tax rates and individual tax rates.

Disclaimer:

The information in this leaflet is not a substitute for professional advice. For specific situations, one should seek proper advice from competent professionals.