

Optimizing Tax Costs relating to a New Business

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Abstract: *A start-up has several options when it comes to the legal structure of the new business. The simplest business set up is as a sole trader/authorized natural person (ANP), but another popular option is a limited liability company (LLC). Each way of forming a new business has different tax consequences, as well as other implications, such as the extent of personal liability for business debts, perception to the outside world or the entrepreneur's training requirement. In this paper we will present the main differences between trading as a sole trader or a LLC in Romania, in terms of the tax consequences, administration and other non-fiscal aspects with regards to the 2017 tax year. This article contains a synthesis of the tax obligations of ANP and LLC and a few practical examples concerning the mechanism of tax optimization regarding the legal structure of the business.*

Keywords: *authorized natural person (ANP), limited liability company (LLC), tax optimization, corporate income tax (CIT), micro-companies income tax (MIT), personal income tax (PIT), social contributions, tax on dividends.*

1. Introduction

Tax optimization includes any decision which leads to tax cost reduction. Tax costs are related not just to the taxes due, but to the deadlines and recovery of claims or losses too. Tax optimization solutions aim at making taxable operations in areas where the level of taxation, tax risks and costs are lowest for the taxpayer.

Newly formed businesses have an important tax planning opportunity. A start-up has several options when it comes to the legal structure of the new business. For a small business there are usually two options in Romania: Authorized Natural Person (ANP) and Limited Liability Company (LLC).

The aim of this paper is to identify which of these options is the optimal solution from a fiscal point of view, in accordance with the conditions of the new Romanian Fiscal Code valid from 01.01.2017. For this purpose we identify which are the steps of tax optimization and when to apply it (section 2).

Section 3 compares companies' taxes (separately for micro-companies and ordinary companies) with freelancers' taxes. We analyze only those taxes that are different for each type of entities: micro-companies income tax / corporate income tax / personal income tax, tax on dividends and mandatory social contributions related to commercial incomes. We do not treat value added tax and social contributions related to wages, because their value is the same regardless of the type of entity (ANP or LLC).

Forecasting incomes and expenses is very important since the start-up. To make use of tax optimization strategies, it is essential that the entrepreneur estimates the revenues and the expenditures for the next few years. This forecast will help him to estimate the overall tax burden and to choose the most effective form of business organization (the one that involves the minimum overall tax burden). The practical examples from section 4 illustrate this process.

In the 5th section we highlight the advantages and disadvantages of each form of organization, taking into account not only the fiscal aspects, but also other specific issues such as: setting-up and split-up conditions, liability for business debts in the case of insolvency, legal status, accounting status etc.

2. What is tax optimization and what are the risks of applying it?

Tax optimization means any activity carried out in compliance with the legislation in order to reduce the tax obligations through:

- Relief, reducing or postponing tax liability;
- Possibility of recovering tax losses;
- Interpretation of the tax legislation in order to obtain the maximum tax deductions and minimize situations where tax deductions are not accepted;
- Carrying out taxable operations in areas where the level of taxation, tax risks and costs are the lowest.

There are five stages of the tax optimization:

- 1) If the ANP/LLC is already set-up we have to analyse the current tax position of the taxpayer. We are looking for:
 - Tax reserves that were not used and that can compensate for the obligations arising from future taxable transactions: tax losses, claims, tax deductions allowed by law;
 - Unreported tax obligations due to incorrect interpretation of the fiscal law or to the legislative changes.
- 2) The second stage is to understand the way in which the taxpayer carries on its operations: the specificity of the activity, the tax obligations, the strategy and the long-term intentions of the taxpayer etc.
- 3) Only after completion of the first two stages will we can develop a tax diagnosis which involves the identification of the fiscal strengths and weaknesses related to the current position and the determination of the tax position for at least two years (given that the tax legislation will not be changed).
- 4) In the fourth stage will develop proposals for tax optimization, with an indication of relevant risks and their feasibility.
- 5) The final stage is implementation of the proposals of tax optimization.

Tax optimization involves certain risks. The main risk is related to the possible association of the tax optimization with tax evasion. However, when the basic principles of tax optimization (transparency, fair price of the transactions, the absence of any abuses of interpretation of tax laws and tax optimization solutions etc.) are respected, risks of assimilation with tax evasion are minimal.

Another risk is the one relating to the incomplete or wrong application of the proposed tax optimization solution, which of course can lead to an inappropriate result or even to the possibility of the association with tax evasion.

Tax optimization should be applied whenever possible, but especially in the following situations:

- At the beginning of the business;
- When major changes occur in the tax legislation with a negative effect (increased fiscal costs) or with a positive effect (the emergence of lower-tax areas);
- Before making a significant change in the activity of the taxpayers;
- Before the liquidation of any business;
- Before leaving the business.

Tax optimization involves looking for the answers to the following **questions**:

- What legal structure would be the most advantageous for a new business, from a fiscal point of view: ANP, LLC, LTD, group, holding?
- What are the main tax reductions, exemptions, facilities which can be applied?
- Which of the business costs cannot be deducted or presents a high tax risk?
- What are the due date of the tax and the possibility to postpone the payment or to compensate it?
- What are the commercial policies which determine the lowest fiscal costs?
- What are the accounting policies the most advantageous for tax purposes?
- What tax obligations arise from the liquidation of a business? What should be done to reduce tax liabilities?

In the following sections we will try to answer to the first question. For this purpose we will first analyse the taxes owed by entrepreneurs depending on the form of organization:

- the companies due: CIT (corporate income tax) or MIT (micro-companies income tax), depending on several criteria as well as the level of turnover, nature of the revenue etc. The entrepreneur dues tax on dividends and in some conditions health insurance contribution for the dividends;

- the authorized natural persons due: PIT (personal income tax) and social contributions (health insurance contribution and social security contribution).

3 Tax obligations for companies

3.1. Micro-companies income tax (MIT)

The newly established legal entities are obliged to pay MIT with effect from the first fiscal year, except for the situation in which it intends to carry out activities in the areas of: banking, insurance and reinsurance, capital market, gambling games, exploitation of petroleum and natural gas.

As of 1 January 2017, according to the Fiscal Code, any newly established Romanian legal entity with a share capital of at least RON 45,000 may opt to become a CIT payer as of its date of incorporation. Previously, for this provision to be applicable, it was necessary to have a share capital of EUR 25,000 or more. [1]

Starting with the second year of operation a company is considered to be a micro-entity paying MIT if other two conditions relating to the level and structure of income are met:

- The first condition refers to the level of incomes obtained in the previous year. From 01.01.2017 the income threshold beneath which a company is required to remain in the micro-entities tax regime has been increased from EUR 100,000 to EUR 500,000 (the equivalent in RON).
- The second condition for application of micro-entities tax regime remains unchanged: the incomes from consulting and management must be less than 20% of total incomes. If during the year this limit is exceeded, the company owes CIT beginning with the quarter in which it has been exceeded.

The taxable base for MIT comprises the income from any source, with several exceptions like income related to the costs of inventories, income related to the capitalised costs of tangible and intangible non-current assets etc.

The 2% tax rate applicable for micro-companies with one employee has been eliminated. Instead, as from 06.01.2017, the new 1% tax rate will be applicable for micro-companies with at least one employee. The 3% tax rate remains applicable for micro-entities with no employees.

3.2. Corporate income tax (CIT)

The companies which do not meet the specific conditions of micro-entities, be it of specific thresholds or income nature, due CIT, calculated as follows:

$$\text{CIT} = 16\% \times \text{Taxable income}$$

The standard corporate income tax rate is 16% with two exceptions:

- The tax due for nightclubs and gambling activities is either 5% of the revenues or 16% of the taxable profit, whichever is higher.
- According to law No. 170/2016 [2], from 01.01.2017 companies with activity in the field of hotels, restaurants, bars and catering (HORECA) apply a specific tax. For hotels, this specific tax is determined in RON / accommodation /year. For restaurants and bars there is also a specific tax in RON / year, but this specific tax is multiplied with many coefficients depending on the rank of the town, the area where the restaurant is located, the restaurant surface, seasonality and the technical space.

According to the Fiscal Code [3], the taxable income is calculated as the difference between the revenue derived from any source and the expenses incurred in obtaining that taxable revenue, adjusted for fiscal purposes by deducting non-taxable revenues and adding non-deductible expenses. Other elements, similar to revenue and expenses, are also to be taken into account when calculating the taxable income.

Expenses fall into three categories: deductible expenses, limited deductibility expenses and non-deductible expenses.

As a general rule, expenses are deductible only if incurred for the purpose of the business.

Non-deductible expenses include, among other items:

- CIT expenses;
- Expenses related to non-taxable revenues;
- Interest, fines and penalties due to authorities;

- Expenses incurred for management, consultancy, assistance or other supply of services if this expenses are not based on a written contract or any other lawful agreement and the company cannot justify the supply of such services for the activities performed and their necessity;
- Sponsorship and patronage expenses and those related to private scholarships. Taxpayers are, however, granted a fiscal credit up to 0.5% of turnover or 20% of the CIT due, whichever is lower.

3.3. Tax on dividends and health insurance contribution (HIC) for net dividends

Every time a company will distribute dividends, it will have to withhold tax on dividends and pay it to the public budget:

Tax on dividends = 5% x Gross dividends

It should be noted that the shareholders are required to pay individual health insurance contributions (HIC) of 5.5% in respect of the net income from dividends, unless they already derive income that is subject to HIC (e.g. salary income, income from independent activities) or they receive pension or unemployment benefits.

HIC = 5,5% x Net dividends

The calculation base for HIC cannot be lower than the gross minimum monthly wage multiplied by 12 months. The health insurance contribution due is calculated by the tax authorities.

4. Sole Trader Taxes

4.1. Personal income tax (PIT)

Income from freelance activities is assessed on the basis of the entries in single entry bookkeeping ledgers, which providers of independent activities are obliged to keep. The taxable base is calculated as gross income minus deductible expenses and the standard personal income tax rate is 16%.

PIT = 16% x (Gross Revenues - Deductible Expenses)

As in the case of CIT, expenses incurred by Authorized Natural Persons fall into three categories: deductible expenses, limited deductibility expenses and non-deductible expenses. Rules of deductibility are very similar to those in the case of CIT. The following expenses are non-deductible: fines, late-payment penalties (other than contractual penalties), donations and other expenses exceeding limits provided by current fiscal law. [4]

Alternatively, specific categories of freelancers are taxed on the basis of a fixed income annual allowance, as communicated yearly by the local tax authorities. [5]

In this case PIT is determined as follows:

PIT = 16% x Fixed income

If ANPs obtain an annual gross income of more than EUR **100,000**, they have to apply the real tax system starting with the next fiscal year.

4.2. Contributions due on income derived from independent activities

The taxable income derived from self-employed activities is subject to social security (pension) contributions (SSC), as well as to individual health insurance contributions (HIC). These contributions should be settled by the freelancers themselves.

The individual can opt for one of these two tax rate of SSC: integral tax rate (26.3%) or individual tax rate (10.5%). The second rate provide only a third of the qualifying period of contribution. The monthly taxation base cannot be lower than 35% of the average gross salary (the one used in the public social insurance budget) or higher than five times the average gross salary. For 2017 these values are:

Minimum monthly taxation base = 35% x 3131 = 1.096 RON

Maximum monthly taxation base = 5 x 3131 = 15.655 RON

Social security (pension) contributions are not due on this type of income if the individuals concerned already derive other income (e.g. pensions or unemployment benefits) that is subject to social security contributions or they receive pensions or unemployment benefits.

The tax rate of of HIC is 5.5%. The monthly taxation base cannot be lower than the gross minimum monthly wage (1.450 RON in 2017) if the income derived from self-employed activities is the only income on which health insurance contributions apply.

5. Case Studies concerning tax optimization for a start-up

To illustrate how to choose the optimum legal structure from a fiscal point of view we will consider an entrepreneur who wants to start a business in January 2017, under the following conditions:

- Annual revenues are the 400,000 RON (this is the only income being earned by this person i.e. there is no other personal income to consider);
- For annual expenses we consider two hypotheses: 100,000 RON and 350,000 RON;
- The activity will take place without employees;
- Regarding the object of activity we will consider two hypotheses:
 - Repair of computers and peripheral equipment (cod Caen 9511)
 - Information technology consulting business (cod Caen 6202)

For this entrepreneur there are two legal structure options: Authorized Natural Person (ANP) and Limited Liability Company (LLC). As LLC, he will pay:

- MIT for cod Caen 9511 (Table No. 1 and 3);
- CIT for cod Caen 6202, because the incomes from consulting and management are more than 20% of total incomes, (Table No. 2 and 4).

As ANP, both activities can be taxed in the normal system or on the basis of a fixed income annual allowance. For 2017, in Bucharest these fixed incomes are: [5]

- 16,800 RON for cod Caen 9511
- 28,000 RON for cod Caen 6202.

If the entrepreneur chooses the fixed income system, this system will be applied also in 2018 because the revenues obtained in 2017 are smaller than 100,000 EUR.

In the tables below we outline the taxes owed and the gains of an ANP compared to a LLC for two levels of expenses and two types of activities. There are four combinations of hypotheses:

- Table No. 1 for expenses of 100,000 RON and cod Caen 9511 (repair of computers);
- Table No. 2 for expenses of 100,000 RON and cod Caen 6202 (consulting business);
- Table No. 3 for expenses of 350,000 RON and cod Caen 9511 (repair of computers);
- Table No. 4 for expenses of 350,000 RON and cod Caen 6202 (consulting business).

Table no. 1 (RON)

	Juridic form	ANP – PIT in normal system	ANP – PIT (fixed income = 16800 RON)	LLC – paying MIT
1	Gross Revenues	400,000	400,000	400,000
2	Expenses, excluding contributions	100,000	100,000	100,000
3	Net Revenues, excluding contributions (1-2)	300,000	16,800	NA
4	SSC-Social security contributions (10,5%*3)	31,500	1,764	NA
5	HIC-Individual health insurance contributions (5,5%*3)	16,500	924	NA
6	Net Revenues (3-4-5) / 3 Gross income (1-2)	252,000	16,800	300,000
7	PIT (16%*6) MIT (3%*1)	40,320	2,688	12,000
8	Net income (6-7)	NA	NA	288,000
9	Dividend tax (5%*8)	NA	NA	14,400
10	Net Dividends (8-9)	NA	NA	273,600
11	HIC for dividends (5,5%*10)	NA	NA	15,048
12	Total taxes (4+5+7+9+10)	88,320	5,376	41,448
13	Total gain (1-2-12)	211,680	294,624	258,552

Table no. 2 (RON)

	Juridic form	ANP – PIT in normal system	ANP – PIT (fixed income = 28000 RON)	LLC – paying CIT
1	Gross Revenues	400,000	400,000	400,000
2	Expenses, excluding contributions	100,000	100,000	100,000
3	Net Revenues , excluding contributions (1-2)	300,000	28,000	NA
4	SSC-Social security contributions (10,5%*3)	31,500	2,940	NA
5	HIC-Individual health insurance contributions (5,5%*3)	16,500	1,540	NA
6	Net Revenues (3-4-5) / 3 Gross income (1-2)	252,000	28,000	300,000
7	PIT (16%*6) CIT (16%*6)	40,320	4,480	48,000
8	Net income (6-7)	NA	NA	252,000
9	Dividend tax (5%*8)	NA	NA	12,600
10	Net Dividends (8-9)	NA	NA	239,400
11	HIC for dividends (5,5%*10)	NA	NA	13,167
12	Total taxes (4+5+7+9)	88,320	8,960	73,767
13	Total gain (6-12)	211,680	291,040	226,233

Table no. 3 (RON)

	Juridic form	ANP – PIT in normal system	ANP – PIT (fixed income = 16800 RON)	LLC – paying MIT
1	Gross Revenues	400,000	400,000	400,000
2	Expenses, excluding contributions	350,000	350,000	350,000
3	Net Revenues , excluding contributions (1-2)	50,000	16,800	NA
4	SSC-Social security contributions (10,5%*3)	5,250	1,764	NA
5	HIC-Individual health insurance contributions (5,5%*3)	2,750	924	NA
6	Net Revenues (3-4-5) / 3 Gross income (1-2)	42,000	16,800	50,000
7	PIT (16%*6) MIT (3%*1)	6,720	2,688	12,000
8	Net income (6-7)	NA	NA	38,000
9	Dividend tax (5%*8)	NA	NA	1,900
10	Net Dividends (8-9)	NA	NA	36,100
11	HIC for dividends (5,5%*10)	NA	NA	1,986
12	Total taxes (4+5+7+9+10)	14,720	5,376	15,886
13	Total gain (1-2-12)	35,280	44,624	34,115

Table no. 4 (RON)

	Juridic form	ANP – PIT in normal system	ANP – PIT (fixed income = 28000 RON)	LLC – paying CIT
1	Gross Revenues	400,000	400,000	400,000
2	Expenses, excluding contributions	350,000	350,000	350,000
3	Net Revenues , excluding contributions (1-2)	50,000	28,000	NA
4	SSC-Social security contributions (10,5%*3)	5,250	2,940	NA
5	HIC-Individual health insurance contributions (5,5%*3)	2,750	1,540	NA
6	Net Revenues (3-4-5) / 3 Gross income (1-2)	42,000	28,000	50,000
7	PIT (16%*6) CIT (16%*6)	6,720	4,480	8,000
8	Net income (6-7)	NA	NA	42,000
9	Dividend tax (5%*8)	NA	NA	2,100
10	Net Dividends (8-9)	NA	NA	39,900
11	HIC for dividends (5,5%*10)	NA	NA	2,195
12	Total taxes (4+5+7+9)	14,720	8,960	12,295
13	Total gain (6-12)	35,280	41,040	37,706

Analysing the results obtained in the four tables, we notice that the entrepreneur obtains the highest gain in the case of ANP paying PIT calculated on the basis of a fixed income. If the object of activity lies in the list provided by local authorities and if the estimated net revenues are greater than the fixed income stipulated in this list, this is the best option.

If the object of activity is not in the list, the entrepreneur must choose between ANP taxed in normal system and LLC. In three of the four cases analyzed (tables 1,2,4), LLC provide a higher gain than ANP.

6. Conclusions

A sole trader has to pay personal income tax and two social security contributions. A limited company, on the other hand, pays micro-companies income tax or corporate income tax, dividends tax and health insurance contribution for net dividends.

For an optimal decision the entrepreneur should consider both taxes (as we saw in section no. 5), as well as other non-fiscal issues, presented in table no. 5. For each of these aspects we have given a “plus” to the form of organization more advantageous and a “minus” to the other form.

Table no. 5

	ANP	LLC
Setting-up conditions	The process of establishing is simple and the cost is less than in the case LLC. +	The process of establishing is longer, requires more documents and the cost is higher than at ANP. -
Specific legislation	Legislative restrictions: • A maximum of five classes of activities stipulated in CAEN; • A maximum of three employees;	Legislative restriction: A LLC has a minimum authorised capital stock of 200 RON. +

	<ul style="list-style-type: none"> • Mandatory professional training in the field of each activity. <p style="text-align: center;">–</p>	
Accounting methods	ANPs can use the cash basis accounting method, which is easiest and least expensive to employ than the accrual method.	LLCs have to use the accrual method. The owners of the LLCs have to rely on expensive accounting professionals.
	+	–
Liability in the case of insolvency	The business owner is personally liable for any taxes and debts the business incurs.	Liability is limited to the extent of capital stock is lodged.
	–	+
Split-up conditions	The process is easier and takes less than in LLC.	The process is wide and can take a long time.
	+	–

Of the two business structures, operating as an ANP has the advantage of simplicity and the disadvantage of unlimited liability (there is no distinction between personal and business assets). In addition, for an ANP may be difficult to bid and accept larger contracts, not only because large corporations have many staff that can work on tenders and offers, but because most companies won't work with a business that has maximum five employees.

Trading as a LLC is generally more complicated, but generates a number of non-financial benefits, among which the most significant is that of limited liability status. A negative issue is the fact that the owner of a LLC can benefit from company's income only in the following year, when the company distributes dividends.

In conclusion, minimize tax costs should be the main criterion in choosing the optimal legal structure of a new business, but other specific issues are also important.

ANP is the right form of organization for those who intend to carry out a limited number of activities (maximum five), with few employees (maximum three) and with few trading partners. Usually the taxation on fixed income is more advantageous than the normal system of taxation.

If the business involves significant investments and the entrepreneur intends to engage in complex activities, with more trading partners, on longer terms and safer, it is preferable to set up a legal person, in the form of LLC or joint stock company, depending on the number of founders and their power of participation.

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