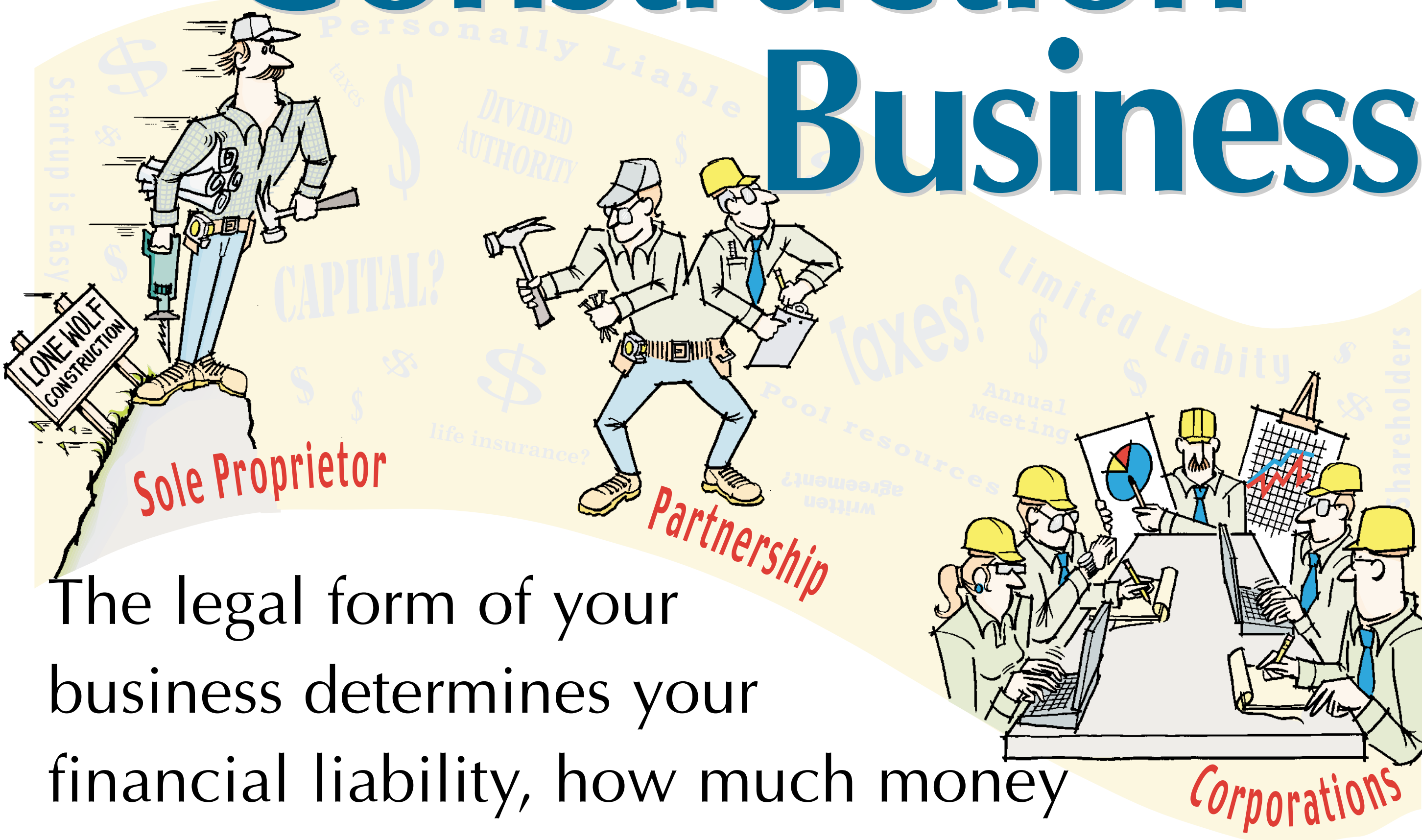
STRUCTURING A Construction Business



The legal form of your business determines your financial liability, how much money you actually pocket, and the taxes you pay

by Milton Zall

Construction business owners have four choices of how to structure their business: sole proprietorship; partnership; corporation ("C" or "S"); or limited liability company (LLC). While many contractors start out as sole proprietors, many others find a partnership or corporation better suited to their business goals. In this article, I'll briefly explain how each type of company structure works, and point out its advantages and disadvantages. Bear in mind, however, that the best structure for your construction business can only be determined by analyzing your individual situation with the help of financial and legal professionals. If you try to fly solo, you will probably regret the decision.

Sole Proprietorship

For contractors who are just starting out, a sole proprietorship is a simple business structure. For legal and tax purposes, there is no difference between you and your company, so startup is easy and inexpensive. If you don't need a state, county, or town license to operate a construction business, and if you're using your own name, there's little you need to do officially to start a sole proprietorship except open a separate business checking account and register for state and local sales tax purposes. If you decide to do business under a company name, you will also have to register the name with the jurisdiction where your business is located. (Call the office of your Secretary of State for registration requirements, which vary by state.)

Operating requirements are also minimal for a sole proprietorship. If you have employees, you will need to obtain an Employer Identification Number (EIN) from the Internal Revenue Service (IRS). However, if you have no employees, there are no payroll duties, since the owner of a sole proprietorship is not considered an employee. As owner, you can simply withdraw money from the company account whenever you need it. The rest of the accounting is easy as well. You don't need to maintain a double-entry bookkeeping system if you don't want to, and you don't have to complete a balance sheet.

Tax reporting is also simple for a sole proprietorship. On federal income tax returns, business income is reported on Schedule C of Form 1040 (most states use a similar approach). This means that any financial losses will pass directly through to you, compared with other company structures, for which it is more complicated to write off losses.

Drawbacks. All of these advantages mean that a sole proprietor can focus his or her time and energy on serving customers, which is crucial to the success of a young construction company. The downside, however, is that the company owner is personally liable for the actions of the business. Since a sole proprietorship does not distinguish between business assets and personal assets, sole proprietors can lose everything in a lawsuit. Also, a sole proprietorship does not allow for a convenient way to add the expertise or assets of a partner. Both of these shortcomings begin to play a role as the business expands.

Partnerships

One solution is a partnership, which is the simplest form of organization involving more than one person. At its most basic level, a partnership is formed by a written agreement between partners who share both the right to manage and the right to participate in the profits. Each also shares the unlimited obligation to answer personally for all liabilities of the business, except in a common variation called a "limited partnership." In a limited

	Sole Proprietor	General Partnership	Limited Partnership
Accounting method	cash or accrual	cash or accrual	cash or accrual
Owner status	owner (not an employee)	partner/employee	partner/employee
Owner payment	regular payroll or personal draw as needed	regular payroll or personal draw as needed	regular payroll or personal draw as needed
Startup & maintenance requirements	Open separate bank account Register for state sales tax Register company name Obtain EIN for employees	Draw up written agreement Establish partners's financial basis Purchase life insurance for partners File Certificate of Limited Partnership (limited partnership only)	
Legal & financial liability	Personally liable	Personally liable; action of one partner binds all	Personally liable; financial risk in proportion to investment
Advantages	Easiest type of business to form Decision-making process is in direct hands of owner All business profits/losses reported directly to owner's income tax return Lower startup costs	Few legal requirements Partners can pool their resources and talents No partnership taxes; partners individually responsible for taxes on personal tax returns Profits and losses may be divided among partners in the manner they choose	Few legal requirements No management responsibility for limited partners No partnership taxes; partners individually responsible for taxes on personal tax returns Limited partner's risk is directly proportional to capital invested
Disadvantages	Owner has unlimited liability Owner could spend unlimited amount of time responding to business needs Lack of continuity upon owner's death Difficult to raise capital	Every partner has unlimited liability Personal assets of any partner can be used to cover business liabilities, regardless of which partner incurred the liability Divided authority	General partners remain personally responsible for all business liabilities/debts Lack of management voice for limited partners Divided authority if more than one general partner

partnership, there are one or more *general* partners liable for the debts of the business with general powers of management, and one or more *limited* partners who have no powers of management and no personal liability for the debts of the business beyond their capital contributions. However, merely stating these limitations in the partnership agreement is not enough to limit the personal liability of partners. To ensure limited liability in most states, a certificate of limited partnership must be filed with the appropriate state or county office and a fee paid.

For tax purposes, a partnership is required to file only an informational return reporting annual income or loss. Like a sole proprietorship, the income is taxed to, or the loss deducted by, the various partners individually on their personal tax returns. The tax obligation may not be equal among partners, since the tax implications for each partner are determined by the partnership agreement, which establishes each partner's distributive share of income, gain, loss, deduction, or credit. Limited partners, for whom the partnership is an investment rather than a job, usually are not employees of the company. General or managing partners who rely on the company for their income must be treated as employees, with all of the attendant payroll recordkeeping responsibilities.

As for liability, the business-related action of any partner usually binds all partners. Even if the partners agree among themselves that the powers of management reside exclusively in a selected few, this agreement will be ineffective against an outsider who had no notice of it.

Pros & cons. A partnership may be a good next step for a sole proprietor whose business has grown beyond the capacity of one person to manage it. A sole proprietor who excels at sales and marketing, for example, may take a partner to manage field production. A partnership will cost more to set up, however, than a sole

S-Corporation	C-Corporation	Limited Liability Company
cash or accrual	accrual	cash or accrual
owner-shareholder, employee-officer	owner-shareholder, employee-officer	member-employee
regular payroll or loan from corp.	regular payroll, dividend, or loan from corp.	regular payroll or loan from company
Obtain corporate charter Pay filing fee (annual) Elect board of directors Hold annual meeting & prepare meeting minutes		Pay annual filing fee and/or annual franchise tax
Some personal protection	Some personal protection	Some personal protection
More expensive to organize Ownership is easily transferable All business profits/losses reported directly to owner-shareholder's income tax return Financial liability of owners/shareholders limited to amount invested	More expensive to organize Ownership is easily transferable Easier access to capital through sale of shares Financial liability of owners/shareholders limited to amount invested	Easy to form Broader management base Member liability limited to personal investment
More extensive record keeping required	Corporate profits may be subject to double taxation More extensive record keeping required	Complex tax filing system; not uniform across state lines Restricted transfer of ownership

proprietorship, and will require more time and energy to operate. In addition to attorney's fees to draw up the original agreement, partners will need to consult an accountant to establish their financial stakes in the business. Partners will also want to purchase life insurance policies that enable the business to survive should one partner die. Day-to-day management is also more difficult, particularly where responsibilities overlap, because partners are obliged to consult with each other when making major business decisions.

Partnerships are also more expensive to dissolve. Unlike a sole proprietorship, which can simply cease doing business, a partnership requires the services of attorneys and accountants to undo the more complex relationships.

Corporations

For most legal and tax purposes, sole proprietorships and partnerships do not make any distinction between the company and the individuals who own the company. Income is reported on personal tax returns, and company owners are personally liable for all business activity. While most construction companies start out under one of these simpler structures, many eventually grow to the point where they need either additional capital to finance expansion or protection from the increased liability of larger jobs. A corporation can fulfill both of these requirements.

There are two types of corporations — regular, or *C-corporations*, and *S-corporations* — each of which is named after a subchapter of the tax law. Both C- and S-corporations are entities that are separate and distinct from the owners. In an S-corporation, however, income is reported on the individual tax returns of owner-shareholders, whereas a C-corporation is taxed as a separate entity. In both types of corporations, owner-shareholders can lose their equity and debt investment, but are generally not held personally responsible for the debts or acts of the corporation. However, a corporation must adhere to certain formalities, including holding an annual stockholders meeting, having a board of directors, and keeping minutes of meetings. It may be perfunctory for a one-shareholder, one-employee business, but failure to observe some of the rules can result in a loss of the corporate protection.

To form a corporation, you will have to apply to the state for a corporate charter. You may be able to do the incorporation yourself, but many companies offer incorporation services for between $100 and $250. You may also be subject to annual filing fees to the state in addition to state income taxes. Most of the fees are minor, but they could add up and affect a smaller business. Discontinuing a corporation is also more expensive. It requires liquidating and dissolving the corporation, which means plenty of paperwork for which you will need the help of both an attorney and an accountant.

Startup expenses. Some of the rules you must follow to preserve corporate protection have to do with accounting procedures. One of the first requirements involves how you deduct startup costs, which can include market analysis, advertising, consultant's fees, rent, employee training, salaries and wages of employees during training, and the cost of labor to make your company ready for business. Unlike sole proprietorships and partnerships, corporate startup expenses are not directly deductible and must instead be capitalized (this limitation applies to new businesses only — see "Tax Talk," 5/98). Although these expenses can be amortized for a period of not less than 60 months, you must be careful to make the proper "election." Some states have a special form for this, but you can lose the right to amortize if you make the mistake of deducting the expenditures in full on your tax return. This error is not correctable and your startup expenditures will not be deductible.

Costs related to the creation of the corporation may be included as a startup expense, but they must be charged to a capital account and amortized over the life of the corporation. (Most corporate charters specify a limited life of 90 years). Examples include legal fees for drafting the charter, bylaws, and minutes of organizational meetings; state incorporation fees; professional fees incidental to setting up the corporation; and the cost of organizational meetings.

Separate entity concept. Since a corporation is separate and distinct from its shareholders, your dealings with the corporation may have tax implications that are not of concern to a sole proprietorship or partnership. For example, if you use a corporate car for personal purposes or sell an asset to the corporation for more than its fair market value, you could have taxable income.

Similarly, corporation owner-shareholders are considered employees and are paid a regular salary, but any other money taken out of the corporation — say, an advance on salary — is considered either a loan or a dividend. Because loans are not taxable as income and dividends are, the IRS pays close attention to withdrawals, considering such factors as the extent to which you as a shareholder control the corporation, whether the corporation has a history of paying dividends, the size of the withdrawal, and how it was recorded on the corporation's books and records. The IRS will also check to see whether you signed a note, provided security, established a fixed schedule of repayment, and made any repayments, among other things. The bottom line is that the IRS scrutinizes loans to shareholders, so you can't just "borrow" money from your incorporated business. Be careful, because even an innocent withdrawal will be considered an attempt to avoid taxation.

Double tax. S-corporation income is taxed through the individual returns of the shareholders, but shareholders in C-corporations can get hit with a double tax. That's because C-corporations are taxed separately on a graduated scale that currently ranges from 15% (for the first $50,000) to 39% (for earnings between $100,000 and $335,000). For example, a corporation with a pretax profit of $100,000 will pay a tax of $22,250, leaving a net profit of $77,750. When that amount is distributed to the shareholders as dividends, they will pay tax on that income. In the 31% tax bracket, that's another $24,103. This effectively reduces the post-tax earnings to $53,647, a combined tax rate of 46%. If the shareholders are in a higher individual tax bracket, the rate will be even higher.

However, if the corporation has no retained earnings — that is, if all the money the corporation earns is paid out in salary and expenses — there is no double taxation problem. Zeroing out retained earnings is a reasonable strategy for a small business, as long as the corporation is not making huge profits. If the company makes too much money, it will be difficult to avoid the double tax by, say, paying higher salaries to the shareholders to reduce retained earnings. The IRS may contend that the compensation is unreasonable and will "recharacterize" the excess as a dividend (see "Tax Talk," 6/99). However, this only becomes a problem if your corporation is earning lots of money. The IRS may question a salary of $200,000 but not, say, $75,000.

Changing your "basis." In both partnerships and corporations, shareholders establish a "basis" when the company is formed. Typically, this is an amount equal to any assets the shareholder contributes to the company at startup, whether in cash, equipment, or services. The basis then determines the amount of losses you can deduct for tax purposes.

One of the benefits of a partnership is that your "basis" includes your share of any debt for which the partnership is liable. This means that an increase in the liabilities of the partnership increases your basis; a reduction in the partnership's liabilities reduces your basis. In the case of a corporation, however, you can increase your basis only by purchasing stock or by making a personal loan to the corporation.

Profits, capital gains, and losses. In a C-corporation, profits either remain in the corporation as retained earnings or are distributed to shareholders as dividends. C-corporation losses are not passed through to the shareholders, but can be carried back 2 years and forward 15 years. If they cannot be used, they expire. A shareholder can, however, get a tax benefit by taking a loss on the stock when the shares are sold or the corporation is liquidated.

Unlike individual capital gains, which get special treatment on your individual return, corporate capital gains are taxed as ordinary income. And unlike individual losses, which can be carried forward forever, corporate capital losses can only be used to offset capital gains, and can only be carried back 3 years and forward 5 years, after which they are lost.

Limited Liability Company

An LLC is a blend of some of the best characteristics of corporations, partnerships, and sole proprietorships. An LLC is a separate legal entity like a corporation, but it is entitled to be treated as a partnership for tax purposes. That means owners, who are called "members," receive a "pass through" of all profits and losses without taxation of the entity itself. Members are also shielded from personal liability, as in a corporation. Unlike the limited partner in a limited partnership, however, a member of an LLC may participate actively in its management without endangering the limitation on personal liability. Like a sole proprietorship, an LLC is flexible and simple to run, and there is no statutory requirement to keep minutes, hold meetings, or make resolutions, requirements that often cause problems for corporate owners. Maintenance costs vary: Most states levy an annual franchise tax, which ranges from as low as $100 (Delaware) to as high as $800 (California). In addition, some states charge an annual filing fee.

One negative aspect of an LLC has to do with disability and health insurance premiums and benefits. Health insurance costs, for example, which are 100% deductible by a corporation, are only 40% deductible by an LLC. Consequently, corporations that switch to an LLC before 2007, when under existing law the 40% deductibility is scheduled to reach 100%, will lose some of its health insurance deduction.

Instead of a buy-sell agreement, which is commonly used to dissolve partnerships, an LLC can use its operating agreement to establish and restrict the circumstances in which a member may withdraw from the LLC as well as to specify the compensation to a withdrawing member, the form of that compensation (cash, property, etc.), and the time at which the compensation should be paid. Such restrictions help to prevent a withdrawing member from jeopardizing the availability of working capital by demanding a cash distribution immediately upon withdrawal. If the LLC has not anticipated the withdrawal, such a demand could force a liquidation of the business.

The LLC is a relatively new entity for the United States, mainly because the IRS wouldn't give an LLC partnership tax classification as long as members were exempted from personal liability for company debts. That position changed in 1988, however, and since then all 50 states have enacted LLC laws. State statutes vary, however, and work is currently in progress on a uniform LLC law that will streamline formation throughout the nation.

The LLC is based upon a very important principle called the "freedom to contract." Basically this means that the members are free to agree among themselves how the company is to be run and that agreement or contract will be upheld in the courts. Currently, however, not enough cases have been heard to test how well this new form of business holds up in the courts. Still, the LLC is becoming the entity of choice for business in every realm and will continue to gain momentum as more and more people learn of its existence.

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