

Best Choice of Business Form for Construction Contractors

Presented by,

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- A. What choices are available to the contractor?
- B. How does the choice of entity affect how much tax the contractor pays? Is there a choice that is clearly better for tax purposes?
- C. Contracting is a risky business. How do the various entities shield the owner from personal liability?
- D. Do any of the entities add administrative or regulatory burdens or increased compliance costs?
- E. Overall, which entity is best and why?

- A. What choices are available to the contractor?

When setting up a business, many times the first decision is what business form to use. There are numerous options. The most frequently utilized forms for construction contractors are sole proprietorship, partnership, corporation (C-Corp), corporation (S-Corp), and limited liability company.

The sole proprietorship is a contractor who is doing business as an individual. He personally owns the equipment, tools, contracts, etc. He also personally owes all the debts of the company.

A partnership occurs when two or more individuals or companies pool resources to form a company. The partnership is an entity that can own assets and liabilities, although the partners are jointly and severally liable for any debts of the partnership.

Many times the partners in the partnership have some type of written or verbal agreement that is their partnership agreement.

A corporation is the most common business form. This is the traditional business where the owner is issued stock in exchange for the capital contributed to the company. The corporation has officers: President, Vice President, Secretary and Treasurer. The corporation can own assets and liabilities. The corporation shields the shareholders from personal liability for the debts of the company. A corporation is created by filing articles of incorporation with the Secretary of State's office. A regular corporation, C-Corporation, is a tax paying entity. An S-Corporation passes its income to the shareholders who pay the tax.

A limited liability company (LLC) is a relatively new statutory creation that is a hybrid between a corporation and a partnership. Like the corporation, the LLC is an entity that can own assets and liabilities and will shield the shareholders (known as members) from personal liability for the company's debts. LLC's are like partnerships and S-Corporations in that it is not a tax paying entity. LLC's are formed by filing articles of organization with the Secretary of State.

B. How does the choice of entity affect how much tax the contractor pays? Is there a choice that is clearly better for tax purposes?

Surprisingly, the choice of entity can dramatically affect the total amount of tax that an owner and company combined will pay. The choice of entity that will minimize the total taxes of the contractor will depend on the individual circumstances of the

contractor's business. Factors such as the individual income tax rate of the owner, the eventual size of the business, the plan for termination of the owner's interest in the company, etc., will affect the choice of entity. However, one business entity, in almost every situation, pays a greater amount of tax than the other entity choices and that is the corporation (C-Corp).

The C-Corp pays corporate rates ranging from 15% to 39% for federal tax purposes. Any time the corporation pays corporate level tax, the funds (equity) that are retained by the corporation will eventually be subject to a second layer of tax when those funds are distributed or paid to the shareholder.

This second layer of tax is at the normal individual rates paid by the shareholder. These individual rates are from 15% to 39.6% for federal purposes. In addition to those rates, the shareholder and corporation will also pay social security and Medicare taxes on that income of up to 15.3%. The total amount of taxes paid on the income earned makes the C-Corp a very unattractive choice of entity.

Many contractors who were originally established as C-Corps have developed methods to minimize those double taxes. But all of those methods contain flaws.

Many owners will simply bonus the entire net income of the company to themselves in an effort not to pay any income tax at the corporate level. While it is true that this will avoid the double tax of the corporation, the owner is running a risk with the IRS. The IRS and tax code requires that all owner compensation be reasonable. Payments to an owner are considered unreasonable when the total wages paid to that owner exceed the amount that would have been paid to an employee who was performing the owner's job. Any payment deemed unreasonable are classified as dividends.

Dividends are taxable to the owner but are not deductible by the corporation. Thus the corporation will pay tax on that dividend and so will the owner. If both the owner and the corporation were in the top rates, this could mean a federal tax of 78.6% (39% corporate and 39.6% individual) and a state tax rate of 7% each for an effective total rate of 65.7%! This happens more often than one would think. Nearly every time I deal with an IRS audit, we're discussing reasonable compensation for the owner.

There are additional risks to being a C-Corp and there are some benefits too. However, C-Corps are not an entity that I recommend in my practice. If I acquire a client who is a C-Corp, I usually look for ways to change their business entity.

The other business models are taxed very similarly. LLC's, partnerships, S-Corps, and sole proprietorships will pay around the same amount of tax overall. However, some of the more minor differences will make one entity choice better than the others.

For sole proprietorships, all income is considered earnings of the owner and is reported directly on his or her tax return. The owner pays 15.3% self employment tax on 100% of the income that the company earns up to \$84,900. For income above \$84,900, the rate is 2.9%. This is in addition to the normal income tax rates. For some small contractors, this will cost them more in taxes than if they were an S-Corp, LLC or partnership.

S-Corps are subject to the same tax rules as are C-Corps except that the double taxation regime has been significantly reduced. The income earned by the S-Corp is passed through to the shareholders and is taxed only one time on their personal return.

While this is a significant improvement over a C-Corp, S-Corps are still plagued by some of the C-Corp rules.

S-Corps are taxed on transfers of appreciated property from the corporation. S-Corps cannot deduct losses in excess of the amount invested and previously taxed. And S-Corps can lose their S-Corp status, or worse yet, if the S-Corp was not set up properly, can have their S-Corp status nullified retroactively from the beginning of the company.

LLC's and partnerships are treated exactly the same for tax purposes. They can freely move assets to or from the company entity without it being a deemed sale. Losses can be deducted up to the owner's risk basis. The risk basis is the amount the owner has invested, plus all amounts earned and taxed to date, and the amount of debt that the owner has personally guaranteed. In addition, if the proper circumstances are present in the business, the earnings may not be subject to the self employment tax.

Thus, depending on the individual circumstances of each business, LLC's and partnerships generally yield a lower tax than other business entity choices.

C. Contracting is a risky business. How do the various entities shield the owner from personal liability?

Shielding the owner from personal liability is one of the most important factors to consider when setting up a business. If set up properly, the business should protect the owner from trade payables, trade related debts and claims from lawsuits. However, no business entity will shield an owner from liability when the owner has personally guaranteed a debt (such as banks require before making a loan or some materials

suppliers require before granting credit.) Nevertheless, an effective shield from payables and lawsuits can be a very effective tool when negotiating with creditors if a business fails.

There is no shield of liability for sole proprietorships or partnerships. LLC's and corporations do provide a shield, but for both entities, and corporations in particular, the legal formalities of operation must be observed or the shield may be lost.

To properly protect the shield of liability, the shareholders of a Corporation or members of an LLC must obey the legal formalities of operating as such an entity. For both entities, this means keeping bank accounts separate from personal, not abusing the company by excessively paying for personal items from the company accounts, not undercapitalizing the company, making sure franchise taxes are paid properly, etc. The businesses must be run strictly as formal businesses.

For corporations, the formalities are more involved. Corporations should have board of directors meetings and minutes, corporate resolutions for various transactions, formal set of bylaws, etc. The board of directors and stockholders must approve certain types of actions of the corporation. The officers should be elected periodically. Even if there is only one stockholder, these formalities must be obeyed, or the corporate shield can be lost.

LLC's must have an operating agreement that defines the relationships of the members; however, they do not require the other types of formalities like a corporation. Therefore, the LLC is the least burdensome entity to obtain a shield from liability.

D. Do any of the entities add administrative or regulatory burdens or increased compliance costs?

Yes. Except for the sole proprietorship, all the entity choices add some level of regulatory and administrative burden. This is the strongest argument for the sole proprietorship. There is nothing that has to be filed and no formalities to be observed.

Partnerships are not required to have a written partnership, however they are, by law, required to register in each county that they do business in. Failing to do so could carry a heavy fine if the business operates in several counties. This law is rarely, if ever, enforced. But the liability is out there for partnerships. Partnerships also file their own tax return which requires a separate set of books to be maintained.

LLC's must file tax returns and maintain separate accounting records, and they must register with the state and pay annual franchise taxes which are usually around \$50. LLC's must also have an operating agreement.

Corporations have the heaviest administrative burden. Along with separate accounting, tax returns, and registering with the state annually, the corporation must also observe the corporate formalities and procedures to maintain the corporate shield.

E. Overall, which entity is best and why?

Overall, if the company's owners can meet the tests for not having their income be subject to self employment tax, then the LLC is the best entity for a contractor. It

generally offers the least amount of tax burden. In addition, it shields the owners from liability. Finally, the administrative burdens are minimal when compared to corporations.