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Business Structure: How to Protect Your Equity

Presented by,

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Business Structure: How to Protect Your Equity

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I. Overview.

The 1990's and the first half of this decade have been boom years for construction. The highway bills, the reformation of downtown Little Rock, and very low interest rates have all contributed to providing a significant expansion of the construction market.

This expansion has placed strains on the construction industry. Labor markets are tight and wages are at unprecedented levels. The modernization of foreign countries has placed extreme strains on the limited construction materials supply causing prices to skyrocket. Significant numbers of new companies have entered construction flooding the market in some segments. Bid lists that previously had three of four bidders on them, now have twelve. It seems like the number of residential home builders has reached an unsustainable level.

The plaintiff's bar has taken notice that contractors are capable of paying huge judgments similar to those paid by insurance companies. They are finding new ways to hold contractors responsible for damages. Whether it is a construction job site accident, a workers' comp claim, or mold infestation, contracting today has never been more risky.

The purpose of this presentation is to educate the contractor or his business advisor CPA or lawyer on the possible options to protect the contractor in this type of environment. This presentation will describe some of the risks that a contractor faces today and offer some suggestions on how to minimize those risks.

a. Caveat.

No asset protection strategy is foolproof. Many of them are decided on a case by case fact by fact scenario. Therefore, you must consult your legal or tax advisor to assist you in implementing any of these strategies.

II. What Are Some of The Big Risks That Contractors Face?

a. Transportation Accidents.

Contractors are constantly in motion. At any given time, a contractor typically has several jobs ongoing in multiple different locations. A contractor's employees move among these job sites sometimes several times a day. Contractors frequently haul materials and equipment to their jobs. Many times the contractor is using employees whose focus is construction and not transportation. They are not experts on loading or transporting equipment or materials. Since these hauls are generally very short, sometimes the same care is not exercised as would be by a long haul trucking company.

In Central Arkansas alone, we have seen several construction transportation accidents ranging from the busted windshield from a stray rock, to the heavy hauler operator that didn't know the height of his loaded excavator when he went under an overpass, to the loaded dump truck blowing a front tire and crossing the I-30 median at high speed during rush hour.

What is the risk to the contractor? What if the damage that occurred is higher than the amount of insurance the contractor has? Is the contractor still responsible when it subcontracts the hauling?

b. Nightmare jobs.

My Dad was a contractor in Rogers, Ark. for over twenty years. He always told me that you had to have ice water in your veins to be a contractor because every job you bid was potentially your last.

I've seen what he was talking about many times. I've seen contractors inadvertently omit hugely significant costs from their bids and still be bound by them. I've seen situations where subcontractors have failed, gone bankrupt, or simply disappeared leaving the general contractor with a terrible mess. Recently, I've seen materials pricing skyrocket such that the contractor's costs tripled before he ever set foot on the job. I've seen a job that was bid at $3,000,000, cost over $4,000,000 to build. Every job a contractor bids is potentially its last.

c. Taxes.

Being CPAs as well as lawyers, we are exposed to another type of significant risk that might not come to mind immediately: taxes. Contractors, along with being required to know building codes, OSHA regulations, transportation regulations, contractors licensing laws, and immigration treaties, must also know and follow the Internal Revenue Code with punishments including fines and penalties, closing businesses, and in some situations, imprisonment.

This presentation will attempt to address the steps a contractor may take to minimize the risks of a horrific accident, a significant problem job, and a costly battle with the IRS.

III. How Can Those Risks Be Minimized?

a. How to Identify and Segregate Risks from Transportation Equipment and Jobs.

As much time and effort as a contractor spends on bidding jobs, managing employees, and creating net income, at least a little of that that effort should be focused on retaining those earnings. In many ways, that can be the role for a good construction CPA or lawyer.

A contractor should evaluate his business to determine areas of risk. For every contractor, those high risk areas might be different. The risk of employee dishonesty, theft, illegal immigration, government regulation, materials supply shortages, or materials price escalation are all areas that could cost a contractor his company and his equity.

This presentation will focus on areas of risk that threaten the equity of almost all contractors: transportation accident risk and job performance risk.

There are many ways to help minimize transportation risk: outsourcing to independent contractors all transportation functions, mandatory drug and alcohol testing for all drivers and operators, installation of GPS systems that can identify unsafe drivers, placing speed governors on vehicles, instituting training programs on how to load equipment and operate the vehicles safely to name a few. However, there is no one, simple, foolproof way to eliminate this transportation risk.

For transportation and job performance risks, this presentation will focus on one method of risk minimization: segregation of enterprises and risks into separate business entities. Using this strategy, a contractor should separate from his main operation and equity reserves all the contractors' risky equipment and high-risk jobs.

For high-risk equipment such as rolling stock, the contractor should establish a separate business entity to own and operate the equipment. The contractor should employ the high-risk equipment operators in that entity.

For risky jobs, the contractor should never contract for those jobs in the same entity that has the contractor's reserve of equity. Instead, the contractor should have a separate company with the minimum equity and working capital required by the contractors licensing law (typically $25,000 in working capital and $50,000

in equity). If a job goes horribly bad, the contractor's liability can be limited to the equity it has in that business.

The separate companies should be owned and operated in a manner that separates it from the contractor's main operation or equity. The following is a sample of how a contractor should structure his enterprises:

		Holding Company		
Rolling Stock Company		Main Operation Company		High Risk Job Company

The bulk of the contractor's equity should be held either outside of its businesses or in a holding company. Contractors who must bond or provide financial statements to owners cannot simply take all their equity out of their companies. Instead they can segregate and protect this equity by placing it in a holding company that does not enter contracts or own significant risk equipment.

The Rolling Stock company should hold and operate the rolling stock of the contractor and any other high risk equipment. All employees associated with the Rolling Stock should be employed and managed in this entity. The Rolling Stock company should contract with the Main Operation company to provide its transportation services for a reasonable price. These contracts should be in writing and updated regularly. The Rolling Stock company should be self-sufficient including having adequate management. The Main Operation company should not provide too detailed a level of direction as such direction may lead to a liability connection between the companies.

The High Risk Job company should maintain an independent contractors license along with the required minimum equity and working capital. This company should be used for any type of new or risky venture or jobs with "problem" owners. This company would contract directly with the job owner and then subcontract the services provided by the Main Operation company along with all other subcontractors. The subcontract agreement with the Main Operation company, along with all other procedures such as submitting pay applications, should be similar to the subcontract agreements used with all other subcontractors. Again, this company should be self sufficient and completely separate and distinct from the Main Operations company.

b. Properly Structure Your Business Operations to Avoid Piercing the Corporate Veil.

When structuring your operations to segregate your liability, some formalities should be observed to prevent a claimant from piercing the corporate veil. The piercing could be accomplished in different ways: piercing through the entity to the stockholders, collapsing the various sister entities to show them as collaborating and operation as a single entity, or holding a contractor liable for its subcontractor agent's actions.

Courts will, with great caution, disregard the separate corporate shield of liability under the following circumstances:

1. The entity attempted to evade the payment of income taxes.
2. It was established to hinder, delay, and defraud creditors.
3. It was established to evade a contract or tort obligation
4. It was established to evade a federal or state statute.
5. The entity perpetrated fraud and injustice generally. [1]

Arkansas cases in which the shield of liability have been pierced have generally involved some fraud or deception.[2] The bar to pierce the corporate veil in Arkansas is high, but observing the following formalities should help prevent a court from disregarding the shield of liability.

For instance, courts will take notice of companies that are not operated separately and collapse them together. In *Winchel,* the court collapsed five different companies where their tax records and payroll slips showed the owners did not operate them as separate companies.[3] Additionally, the court in *Winchel* disregarded the entities altogether and held the stockholders personally liable when it found that the corporations had no liability insurance, the assets of the corporation were sold or transferred subsequent to suit being filed, that the stockholders made no provision for payment of creditors before dissolving the corporation, and one month before these actions took place, the shareholders formed a new corporation that would perform the same operations as the defendant companies.[4] Similarly, the court held the shareholders personally liable in *Anderson v. Stewart* where a check cashing company did not employ a company CPA, the corporate accounting records were limited or unreliable, the tax returns

[1] *See H.* Murray Claycomb, *Arkansas Corporations,* §§ 3-15 (1991); *see also* C. J. S. *Corporations, §*9 (1990).
[2] *See EnviroClean, Inc., v. Arkansas Pollution Control & Ecol. Comm'n*, 314 Ark. At 104, 858 S.W.2d at 120.
[3] *See Winchel v. Craig,* 55 Ark.App. at 381-82, 934 S.W.2d at 950-51.
[4] *See id.*

appeared improper, the stockholders withdrew a letter of credit and cancelled a company bond shortly after suit being filed, and after the business closed, the shareholders were operating a similar business under a different corporate entity.[5]

Several cases have provided circumstances where the corporate veil will not be pierced and sister companies will not be collapsed. These cases serve as a guideline for contractors to follow to help ensure their corporate shields will be upheld in a time of crisis.

1. Incorporators took all necessary steps to establish a corporation, the shareholders attended corporate meetings, and tax returns were properly filed. The only evidence of illegality was that corporation's ferry was not licensed, but the ferry was operated by a lessee and not the corporation.[6]

2. No collapse of two corporate entities where there was no interchange of employees, facilities, funds, or management between two companies owned by the same individual. The companies were on two separate properties, had separate books, filed proper tax returns, and had separate liability insurance.[7]

3. No piercing of the veil where corporation kept its own financial records and bank accounts, filed separate tax returns, and properly recorded all loans between it and its shareholders.[8]

Another source of liability that a contractor should be aware of is that it can be held liable for the acts of its subcontractors or "agents" as the law would classify them. The law has long held that a master is liable for the acts of his servants.[9] In the construction context, this means a contractor is liable for the acts of its "employees." The term "employee" can mean any individual or any other company that the contractor directs, supervises, or controls the performance of its work.[10] There is no fixed formula for determining whether an entity is an employee or an independent contractor. The determination is made based on the particular facts of each case compared against the following ten factors:

1. The extent of control, which by the agreement, the master may exert over the details of the work.
2. Whether the employee is engaged in a distinct business.

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[5] *See Anderson v. Stewart*, ___ S.W.3d ___ (2006) WL 1118892
[6] *See Don G. Parker, Inc. v. Point Ferry, Inc.,* 249 Ark. At 766, 461 S.W.2d at 589.
[7] *See Banks v. Jones,* 239 Ark. At 399, 390 S.W.2d at 110.
[8] *See Quinn-Matchett Partners v. Parker Corp.,* 85 Ark.App. at 149-50, 147 S.W.3d at 707.
[9] *See Blankenship v. Overholt,* 301Ark. 476, 786 S.W.2d 814 (1990).
[10] *See Draper v. Conagra Foods, Inc.,* 92 Ark.App. 220, ___ S.W.3d ___, (2005) WL 2175911.

3. In the locality, whether the employee's work is normally done by an employee or an independent contractor.
4. The skill required by the employee in that profession.
5. Whether the contractor or subcontractor supplies the instrumentalities, tools, and place for work.
6. The length of time the work is performed.
7. The method of payment – by time or the job.
8. Whether the work is a regular part of the employer.
9. Whether the parties believe they are creating a master servant relationship.
10. Whether the subcontractor is or is not a business.[11]

While the law clearly states that a contractor is liable for the acts of its employees, the law is equally clear that one who employs an independent contractor is generally not liable for the acts of it in the performance of the contracted work.[12]

The law defines an independent contractor as one who contracts to do his own job according to his own method and without being subject to the control of the other party except as to the result of the work.[13] The right to control the means and manner of performance, not the result, is the principal factor in determining the status as employee or independent contractor.[14]

Courts will take notice whether the subcontractor was operated as a distinct and separate business or was merely a part of the master corporation's regular business.[15] The more that the work done by a subcontractor resembles that work done by the employer, the more a master servant relationship seems to exist.[16]

In *ConAgra*, the court reversed the granting of summary judgment on the issue of whether a master servant relationship existed between ConAgra and its trucking company, PST. In that case, there was a twenty-seven year old agreement that spelled out the terms of their relationship and clearly indicated that the parties were independent from each other. Facts to the contrary were that PST had only one customer: ConAgra; PST's drivers picked up their load instructions at ConAgra's facilities; and ConAgra would take issue if a PST driver took too long of a coffee break. While the court noted that most of the factors indicated an independent relationship, it did note that the amount of detailed control exercised by ConAgra over PST's drivers could create a question of fact for a jury to determine if the two companies were truly independent or not.

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[11] *See* Restatement (Second) of Agency §220 (2) (1958).
[12] See *Stoltze v. Arkansas Valley Elec. Co-op Corp.,* 354 Ark. 601, 127 S.W.3d 466 (2003).
[13] See *Arkansas Transit Homes, Inc., v. Aetna Life & Cas.,* 341 Ark. 317, 16 S.W.3d. 545 (2000).
[14] *See Draper v. ConAgra Foods, Inc.,* ___ S.W.3d. ___, 92 Ark.App. 220, (2005) WL 2175911 *citing Arkansas Transit Homes, Inc., v. Aetna Life & Cas.,* 341 Ark. 317, 16 S.W.3d. 545 (2000).
[15] See *Id.*
[16] See *Id.*

Therefore, for a contractor to have the best chance of segregating his equity away from his high risk operations, the contractor must observe the formalities of operating each segregated enterprise as a truly independent business. This would include contracts between the companies, billing statements, market pricing, etc. Essentially, for the business to be considered separate, their businesses must be conducted as if they were truly separately owned and operated.

IV. Best Choice of Business Form for Construction Contractors

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 (most frequently) not a tax paying entity. LLC's are formed by filing articles of organization with the Secretary of State.

b. 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.

c. 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 agreement, 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 $150. 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.

d. Overall, which entity is best and why?

Overall, the LLC is the best entity for a contractor. It generally offers the least amount of tax burden. It shields the owners from liability. Finally, the administrative burdens are minimal when compared to corporations.

V. New Tax Laws and Tax Savings Tips for Construction Contractors

(The following explanation of the tax system applicable to contractors has been oversimplified and is intended for a general discussion only. Therefore you must consult your tax advisor to assist you in implementing any of these strategies.)

a. General overview of how contractors are taxed.

Construction contractors are taxed on the amount that net assets (less liabilities) increased from the same period 12 months prior. This is different from what most contractors think of as "income." However, the tax code allows income to be defined numerous different ways - some of which can be used to the advantage of a growing contractor.

b. What are the different bases of accounting available to construction contractors and how does this save taxes?

There are numerous bases of accounting (or different definitions of income) allowed for construction contractors. They are cash basis, accrual basis, completed contract basis, and percentage of completion basis. Each of these methods calculate income based on the accumulation of certain assets and excluding others.

The cash basis, as its name implies, calculates income based on the accumulation of cash over the previous twelve-month period. Therefore, under the cash basis, accounts receivable, retainage, work in progress, and prepaid assets are not considered to be a part of income for tax purposes. Because of the nonrecognition of so many assets, it is common for a contractor to show significant income for financial statement purposes and to show a loss for tax purposes. For this reason, the cash basis is a very attractive method for those contractors that can qualify to use it.

To qualify for use of the cash method, the contractor cannot maintain significant inventory, cannot average more than $10,000,000 in gross revenues for the past three years, and the use of the cash method cannot significantly distort income. (The gross revenue limit is $5,000,000 for C-Corporations or partnerships with a C-Corporation partner.) There is a safe harbor rule for contractors who gross under $1,000,000; they can use the cash method regardless of maintaining

inventories. If a contractor qualifies for this method, in almost all situations, it will result in lower taxes than other methods.

For contractors who do not qualify for the cash basis, usually their next best alternative is either the accrual method or the completed contract method. To determine which of these options is better, the individual circumstances and industry of the particular contractor must be analyzed.

The accrual method taxes the net increase in cash, accounts receivable, and other types of prepaid assets to calculate taxable income. This method excludes retainage and deficit billings. Like the cash method, excluding the accumulation of retainage and work in progress can result in a situation where the contractor is able to show significant income for financial statement purposes while minimizing taxable income.

The completed contract method taxes job profits only upon completion of the project. Thus all work in progress, including all billings and expenses, are excluded from taxable income. This method is generally preferable to the accrual method for contractors who do not carry large retainage balances.

Percentage of completion method of accounting is the same method of accounting that is generally required to be used for financial statement purposes. All increases in net assets are included in the calculation of income for tax purposes. Thus, it is very difficult to have a year where the taxable income is much lower than the income shown on the financial statements. Because this method of accounting does not exclude any type of asset, contractors generally do not use it for tax purposes if they have a choice. The percentage of completion method of accounting is required for contractors who gross in excess of $10,000,000 for a three-year average.

C. Other tax tips for construction contractors.

Construction contracting is a very equipment intensive business. There are a couple of rules relating to the depreciation of equipment that contractors generally can use to their advantage.

Section 179 Expense Deduction is an equipment investment incentive provided by Congress to stimulate small businesses to invest in equipment. This rule allows a contractor to immediately deduct the first $108,000 (year 2006) worth of new or used equipment purchased in the year of purchase rather than depreciating it over several years. This applies regardless of whether cash or debt is used to pay for the asset. On December 31st, a contractor may simply sign a note for a new piece

of equipment and immediately create an additional $108,000 of expense deductions for his company.

There are a few limitations for use of this rule. This rule applies only to contractors who purchase less than $430,000 (year 2006) in equipment per year. The deduction cannot create a tax loss for the contractor. If there is no income, the deduction will be carried forward until there is sufficient income to utilize the full loss. Additionally, the equipment purchased must meet certain qualifications. Generally all construction equipment will qualify.

For vehicles, there are a myriad of new rules. Normally vehicles are subject to tight depreciation deduction rules that make them very unattractive as a tax deduction. However, trucks (including pickup trucks) and vans that have a gross vehicle weight over 6,000 pounds are eligible for the full $108,000 depreciation deduction. Sport Utility Vehicles placed in service after Oct 22, 2004, are limited to $25,000 plus the remainder of its cost over five years. Also exempt from the vehicle depreciation limitations are trucks and vans less than the 6000 gross vehicle weight that have been specially modified in such a way that they are not likely to be used for personal purposes. Hybrid vehicles qualify for up to a $3,500 tax credit.

For contractors who have heavy machinery, such as excavators, asphalt pavers, etc., **the timing of repairs** can result in tax savings. If the contractor is having a high tax year, one in which the contractor may be paying higher tax rates such as 35%, the contractor should look to replace worn out parts, and undertake other repairs during that year. The tax savings could cut the "real" repairs expense by a third.

The most important thing when considering any type of tax savings strategy is the potential impact on the contractor's financial statements and the related ability to obtain bonding. Most of the savings tips mentioned in this presentation, if managed correctly, will not have a significantly negative effect on the contractor's financial statements. The contractor will be best served when there is an adequate emphasis placed on protecting the bonding program and the CPA works closely with the surety agent.

D. What's new this year that might affect construction contractors?

- Manufacturing Deduction §199 – There is a new deduction available for contractors that allows the contractor to deduct a certain percentage of net income made from construction activities. This deduction is 3% of net income derived from construction during 2005 to 2006; 6% for 2007

to 2009; and 9% thereafter. This deduction is limited to 50% of the taxpayer's W-2 wages and qualified deferred compensation.

- The exemption for the estate tax has changed, but it is a hollow change. In 2003, the estate tax exemption was $1,500,000. In 2006 the exemption rises to $2,000,000. In 2009, the exemption rises to $3,500,000. There is no estate tax for 2010. And the exemption drops to $1,000,000 starting in 2011.
- Personal residence exclusion has increased to $500,000 for the sale of a personal residence previously occupied for not less than 2 years.
- *Hospital Corp. of America, 109 TC 21*. This case recently stated that not all components of a building must be depreciated over the usual 39 years allowed by the IRS. Instead, certain components of the building may be depreciated using much shorter lives such as 7, 10, and 15 years. Examples of items that may, under certain circumstances, be depreciable under faster methods are as follows:

  carpeting
  awnings or similar
  blinds, shades, shutters, drapery
  security lighting, battery powered lighting
  standby generators along with fuel taxes, lines, alternator and controls
  detachable fire detection and security systems
  exterior lighting, landscape/decorative/accent lighting
  exterior ornamentation, landscaping
  detailed crown molding, ornate wall paneling
  movable partitions or walls
  plumbing for cafeteria equipment
  signs
  curbs, sidewalks, driveways, roads, parking lots, drainage facilities
  playground equipment
  fencing