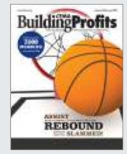

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Tax Advantages & Disadvantages of Multiple Entity Structures

Business-minded contractors are constantly reviewing and strategically expanding their service offerings and product mix, often entering into new lines of business to stay competitive. While periodically reevaluating your company's offerings and launching new endeavors can be beneficial to its financial health, it's the CFM's responsibility to make sure the underlying organizational structure selected is the best suited for the particular circumstances. It's critical to be aware of the financial and operating implications of selecting one or multiple entity formation options for those new ventures, and furthermore, to understand the tax implications of selected structures.

First and foremost, CFMs must be in concert with the owner's business strategy and future plans and have a clear understanding of where the company is heading. It is also crucial that the company's key managers and employees are aware of the plan and work together to achieve common goals. This requires constant communication regarding management's goals – both financial and personal.

CFMs must also understand and evaluate the various entity forms and the advantages and disadvantages of each. As your company's key financial advisor, you need to be able to clearly explain the benefits and pitfalls of the entity structure you are advising to implement.

Limited Liability Company

The LLC is a common entity selection in the construction industry because it offers owners significant flexibility and has fewer regulations regarding structure and ownership. An individual or almost any type of entity can own part or all of an LLC. There is also significant flexibility regarding the allocation of profits and losses to the various LLC members, which is ideal when members have varying amounts of involvement or investment.

LLCs also qualify for pass-through taxation, which means that no entity-level income tax is assessed in most jurisdictions; that is, cash draws from company profits are generally not subject to taxation to the extent the LLC member has sufficient basis. (An LLC member's basis can be defined as the member's initial investment, plus or minus income or loss items allocated to them, plus any company debts for which the member is personally liable.) An LLC also offers owners increased legal protection from creditors and lawsuits as compared to a sole proprietorship, and reduces the possibility of owners' personal assets and/or other related segregated corporate assets of being at risk.

However, there are some drawbacks. LLCs require detailed ownership agreements upon formation, and any omitted items may be very difficult to resolve. Also, any ownership changes in excess of 50% within a 12-month period may result in unintended entity dissolution. In addition, many states have franchise taxes and filling fees for LLCs, even for those with little or no activity or profit.

C Corporation

The traditional C corporation structure offers construction companies a number of benefits. Like the LLC, it offers increased legal protection for owners compared to operating without an entity and provides flexibility in ownership structures – ownership can be easily transferred, and there are no restrictions on the number of owners or classes of stock. C corporations at low income levels are subject to lower tax rates and can potentially qualify for an exemption to the alternative minimum tax (AMT), which commonly impacts contractors that report taxable income using the completed-contract method.

However, C corporations are taxed twice – once when earned and again when distributed to the owners. This can be a huge drawback for profitable businesses, as corporate income tax rates graduate to the top bracket rapidly. Additionally, all capital gains are taxed at ordinary income tax rates rather than at the preferred long-term capital gains rate for individual taxpayers. Finally, losses are captured at the entity level and cannot be passed through to owners.

S Corporation

The S corporation possesses certain characteristics of both an LLC and a C corporation. As with an LLC, the S corporation qualifies for pass-through taxation. Distributions are generally not subject to income and self-employment taxes. With the S corporation's standardized structure, establishing the entity is quite easy, and there's no threat of deemed dissolution due to a majority ownership change. Similar to a C corporation, ownership can be easily transferred and new shares can be issued in order to bring on new shareholders.

Because of the standardized structure, there is not much flexibility when it comes to how the pass-through results are allocated. Only one class of stock may be issued, and all allocations are based solely on ownership percentages. In addition, there are restrictions on the types of owners that are eligible to participate: An S corporation can only have 100 shareholders and they must all be U.S. citizens. There are also limitations on non-taxability of fringe benefits (e.g., health insurance).

Choosing the Right One

Selecting the appropriate operating entity is, of course, dependent on a case-by-case analysis of a company's specific situation and long-term plan. Let's look at some considerations.

LLCs for Real Estate Investment

For business activities involving real estate investment, an LLC is frequently the preferred option. An LLC allows for members to allocate profits and losses as they deem necessary in the operating agreement, which means members can specifically allocate more profits to members who are more active in the business or provide a preferred return to a particular investor. An LLC also affords the ability to gift membership interest to others, for example, trusts of children, with no new deed transfer taxes or recording fees. This strategy is a great way to assist in estate-planning activities.

Furthermore, IRC §754 provides for a "step-up" in basis at death, divorce, or buyout of a partner. The §754 "step-up" is amortized over the life of the underlying asset, effectively providing a double deduction as amortization is not recaptured at the time of sale. Finally, investment interest related to the debt that was used to acquire the property is passed through annually to the LLC members and can be used to offset unrelated investment income in the current period on the member's individual tax return.

There are also considerable tax benefits related to real estate investment activities within an LLC. If you sell an investment property held for more than one year, then the income is taxed at preferred long-term capital gains tax rates of 20% vs. ordinary tax rates of up to 39.6%. There's also generally no self-employment tax on the earnings of the LLC, which can be a savings of 2.9% to 15.3%.

LLCs for Real Estate Rental Activities

LLCs are also preferred for business activities related to real estate rental activities. In an LLC, the underlying debt used to purchase the property increases an owner's basis to take losses, which is not the case with a C or S corporation. Additionally, the net investment income tax of 3.8% recently implemented as part of the *Patient Protection and Affordable Care Act* is generally not applicable due to the self-rental rules and real estate professional status, both of which are common among contractors.

Self-rental refers to the renting of a property to an entity in which the owner of the property materially participates. The self-rental rules provide that an activity which is otherwise passive is deemed non-passive as a result of the self-rental, and therefore not subject to the net investment income tax.

Passive loss rules are also not applicable as most contractors will qualify as real estate professionals per the IRC. The real estate professional status is achieved by spending a minimum of 750 hours per year in real estate-related trades, for which most construction activities qualify. Depreciation expense is deducted at ordinary rates up to 39.6% and is recaptured at sale at 25%, which results in a tax rate arbitrage of 14.6%. Cost segregation can be performed to expedite depreciation expense deductions.

S & C Corporations for Construction Operations

Construction operating companies often consider both the S and C corporation options because of their ownership structures. Unlike investment ventures or holding companies, operating companies have greater potential for actual conflict among the owners (e.g., compensation, cash flow, strategy, staffing, personality, etc.). Consequently, operating companies often select to become either a C or an S corporation. The real decision usually boils down to the AMT concerns and how fast the company expects to grow revenues past the small business corporation threshold, and the overall effective tax rates of the company and owners.

C Corporation Benefits & Pitfalls

Both types of entities have distinct benefits. C corporations offer several key tax advantages for lower taxable income levels: a 15% tax rate for the first $50,000 of income and only 25% on the next $25,000. If a corporation averages annual gross receipts of less than $7.5 million over a three-year period, then it will qualify as a small business corporation under IRC §55(e) and be exempt from the AMT. As noted earlier, this can be extremely beneficial to taxpayers using the completed-contract method.

A C corporation is a great vehicle for raising capital. It allows owners to issue more shares and create second classes of stock with different rights and capabilities. For example, owners could create a Class B stock that does not have voting rights, but shares in earnings. Since it's common for owners to want investors to have limited business involvement, this is a valuable ability. And, for contractors that have willing investors from a foreign country who wish to participate and help capitalize the business, C corporations are optimal.

The main drawback for C corporations is double taxation on earnings from the business. Although tax rates are low for companies with low income levels, the only way to get money out of the corporation is through dividends or compensation. As such, all income from C corporations will be taxed both at the entity and shareholder levels. Capital gain income is taxed as ordinary income and not at preferred rates, and net operating losses generated by the company cannot be passed down to the shareholders.

S Corporation Benefits & Pitfalls

Many small- and medium-sized construction contractors typically choose to become S corporations for their primary operating entity because many of the disadvantages of the S corporation are not consequential to a sole owner or a small group of owners. Compensation differences due to levels of involvement can be handled through wages, and capital raises and foreign ownership are not mitigating factors.

With its one level of taxation, an S corporation can be appealing. All income or losses are passed through to the owners. Earnings from S corporations and related cash distributions are also not subject to self-employment tax; however, continued signals from Congress indicate that this may change in the future for higher income earners.

The primary disadvantage of S corporations is related to restrictions in ownership structure – there may be no foreign owners, no corporate owners, and no more than 100 shareholders. Furthermore, S corporations may have only one class of stock. Therefore, all owners have voting rights and increased say in business matters.

Converting from a C to S Corporation

Some construction companies decide to start as C corporations and eventually convert into S corporations, and could therefore be subject to the built-in gains tax. Many owners who expect that they won't be profitable or have substantial profits in the early years of the business prefer to start as C corporations so that they are exempt from AMT. Although a conversion is possible, the built-in gains tax could come into play.

The net value of appreciated assets in the C corporation, which would not yet be taxed, will be subject to the built-in gains tax for the 10-year period (five years in some limited circumstances) following conversions. Built-in gains are taxed at a flat 35% at the entity level. Therefore, the taxable income reported by the S corporation, up to the amount of built-in gain income as determined at the date of conversion over the next 10 years, will be subject to an entity level tax of 35% in addition to the tax levied at the shareholder level. Effectively, the contractor will be subject to double taxation on any deferred income earned but not yet taxed while a C corporation through the date of conversion. A common issue is the conversion to an S corporation for a contractor using a deferral method such as the completed-contract method, which has a possible built-in gain on the net income deferral.

Multiple Entities

In many cases, contractors elect to separate different lines of business into individual companies with a variety of entity types. There are a number of instances where this strategy can be appropriate and beneficial.

Equipment & Vehicles

Consider putting high-risk equipment (including transportation equipment) and its operators into a separate entity. Since equipment can present a higher risk of claims, separating it into another entity will help protect personal and other corporate assets.

Appreciating Assets

As discussed earlier, appreciating assets should be segregated to provide liability protection, flexibility for estate planning, and to ensure capital gain at time of disposition.

Multi-State Activities

Depending on the type of work and the states involved, creating separate entities for different jurisdictions can be worthwhile when operating in states with high tax rates. However, many states require unitary filing, which eliminates the benefit of this segregation. Be sure to determine if the states in which you do business have adopted this model before implementing this strategy.

Preparing for Future Sale

Maintaining separate entities for different lines of work makes selling a specific division much simpler. Trying to bifurcate an ongoing business is difficult and time-consuming. This is often a good way to transfer partial ownership to key employees who may be suited to a particular line of work as part of your succession plan.

Joint Ventures

When joining with an outside party on a new project, the risks increase. Be sure to segregate the activity to minimize risk and monitor performance.

Holding or Management Company

Regulations regarding qualifications needed for a project are often limited to the operating company – significantly expanding your opportunity to bid on work. A holding company also offers the potential to commingle income and losses from multiple C corporations without commingling liability. This structure also provides an opportunity to maximize deductions (e.g., IRC §199 domestic production activities deduction (DPAD)), creates centralized overhead for multiple entities, and reduces staffing.

Multiple Entities Are Not for Every Company

Cash flow among multiple entities can be cumbersome; detailed records must be kept, loans need to be recorded, and interest charged. Companies could unintentionally create additional taxes due to organizational structure, and often overlook sales tax and gross-receipts-based taxes with affiliated company transactions. The impact of the variable interest entity (VIE) requirements can impact your financials, so be sure to discuss any new entities with your bank and bonding company first.

Multiple entities are more expensive to maintain; they require multiple tax returns and filing fees as well as associated professional fees. Shareholders may often be required to guarantee loans of other entities, which reduces the protection of other corporate assets. Finally, pay special attention to employee benefit plan rules and regulations.

Final Considerations

Choosing the right entity type (or types) is critical to sound financial planning. CFMs should periodically review entity types and the possibility of separating lines of business. Ideally, the CFM should collaborate with a CPA that is well versed in the construction industry and assemble a team of stakeholders (e.g., the owner, estate planner, insurance provider, tax planner, financial advisors, etc.) to explore the potential benefits and pitfalls of all entity structure options. ■

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