Choosing the Right Entity for Maximum Tax Benefits for Your Construction Company

Timely re-evaluation of choice of entity will enhance the shareholder value of your contractor client
Construction Entity Selection

All construction companies at some stage in their life cycle assess the tax benefits of their specific entity type—an S corporation, an LLC, a partnership, etc. There are numerous factors behind this decision, and this article addresses the advantages and disadvantages of various entity type choices. It is important to review your choice of entity at various times during your life cycle because the decision criteria you used to elect a certain type of entity may not be the same criteria facing you today.

Five types of organizational structures

We believe there are five different types of organizational structures a contractor should consider, including:

1. A sole proprietorship
2. A limited liability company, or LLC
3. An S corporation
4. A partnership
5. A C corporation

As a construction company progresses through its life cycle (birth, growth, maturity, and eventually decline) there are certainly obstacles, opportunities, and strategies that accompany each stage. Entity choice is classified as one of those strategies.

Sole proprietorship

One choice of entity allowable for construction companies is a sole proprietorship. This is the simplest choice of entity because any income and/or losses from the sole proprietorship construction company are simply reported on Schedule C of the owner’s Form 1040. This income is subject to self-employment tax.

Advantages of sole proprietorship are:

- Ease of formation and execution;
- Ability for proprietorship to pay wages to children under 18 without any employer level FICA or FUTA tax; and
- You can implement a qualified retirement plan to include both yourself and your employees, which may also include your children.

Disadvantages of the sole proprietorship are:

- You have unlimited liability, which means essentially all your personal assets are really at risk; and
- You are going it alone versus sharing some of the risk/reward with another shareholder.

Limited Liability Corporation (LLC)

The second entity choice is a limited liability company (LLC). There have been limited liability companies elected for construction companies based on liability protection. An LLC is a legal entity formed by filing Articles of Organization. The issue for contractors is (depending on what state you are working in) they may or may not accept LLCs as viable entities.

LLCs do offer some advantages to contractors, including:

- Limited liability. Most investors in an LLC are generally limited to the amount of money they have invested;
- Flexibility in ownership. In my experiences, LLCs are much more flexible than S corporations. There are no restrictions on who may own, such as a non-resident shareholder, and/or the number and type of shareholders that can be members of an LLC;
- Like the S corporation, there is no federal income tax, and all income is reported by the shareholders; and
- A real key advantage of LLCs is the allocation of income. In an S corporation, income is allocated per ownership. In an LLC you have flexibility to allocate income as you want.

There are obviously some disadvantages. These disadvantages are:

- Some states do not recognize LLCs, and it may be difficult to begin operations in these particular states.
Single-member LLCs

Single-member LLCs carry a distinct importance that can’t be overlooked. For income taxation, a single-member LLC is a disregarded entity, and all income or losses are reported on the member-owner’s Form 1040, Schedule C. The single member does provide liability protection for its member, and this is a big advantage over a sole proprietorship choice of entity. There are opportunities to utilize a single-member LLC for a certain project. You would simply have your regular choice of entity (an S corporation or an LLC) be the member of the new LLC. You would have protection if the new job did not go according to plan.

Subchapter S corporation

A subchapter S corporation can offer a growing construction company real benefits, primarily the overall reduction of taxes. S corporations are taxed like partnerships as all income and/or losses are passed through to the shareholders who report income and losses on their individual Form 1040 tax returns.

S corporation eligibility

There are some key procedures for a corporation to be eligible to elect S status. Eligibility is available to those companies who:

1. Are a domestic corporation;
2. Have less than 100 shareholders;
3. Shareholders can only be: individuals who are citizens or residents of the U.S.; estates; certain types of trusts; and Section 501 C (3) charitable organizations. (In this case non-resident aliens of the U.S. cannot be a shareholder in an S corporation);
4. There can only be one class of stock, but voting rights between first and second class of stock is allowed.

A number of advantages are offered by S corporations to construction contractors, such as:

- The S corporation pays no federal tax;
- The losses to the extent of basis are passed through and deducted on the shareholder’s 1040;
- There is no excess compensation and/or accumulated earnings tax issues, like with the C corporation;
- The distributions are considered dividends and not subject to self-employment or Medicare tax, such as compensation from a C corporation; and
- One of the principal benefits is that there is only one tax on liquidation. We advise a number of family business construction companies on transitions and succession planning of this benefit.

S corporations, however, do have some disadvantages, such as:

- There are a limited number of shareholders;
- Certain fringe benefits do get taxed; and
- Losses can only be deducted to the extent of shareholder basis. Likewise, there is no small corporate AMT exemption available to S corporations like there is with C corporations.

Today we see an abundance of S corporations as the choice for construction companies. In recent history, most construction companies were making money, which accounts for the abundance of S corporations. The taxable income was most beneficial being reported in an S corporation, where there was only one tax that was being reported on the shareholder tax return. In the past few years, as construction companies have seen their profits decrease and losses reported on the company’s financial statements, these losses can be offset against shareholder compensation and other income if there is sufficient basis.

S corporation basis. The challenge recently, as tax losses have increased over the years, is whether shareholders can deduct the losses. A strategic approach entails loaning money directly to the S corporation—a shareholder creates basis in the corporation, which allows you to then deduct the losses. Today, we are having numerous discussions with S corporations’ shareholders and their bankers about creating a basis by borrowing money and loaning directly to the company to deduct losses. If there is no basis, the losses created during the year...
are suspended and carried over to be used in future years when income is created in the corporation.

**Timing of S corporation “election”**.

One of the key requirements for electing S corporation is the timing of the election. The election needs to be made by the 15th day of the third month of the corporation’s existence. It will then be effective for that year. The election must be submitted to the IRS on Form 2553 and signed by all shareholders, including their spouses. This is a key issue often missed with filing for S corporation status. Once approved, the IRS issues the company an S Election Notice. Do not lose it!

**S corporate year-ends.** The last decision about S corporation is year-end. Usually, the IRS will only allow an S corporation year-end for September 30, October 31, November 30, or December 31. If there is a year-end other than December 31, the S corporation completes a Form 8752 and makes a required payments based on the amount of the income being deferred. This is an annual calculation. It is not complex, but your money will be tied up with the IRS on deposit until the next filing period.

S corporations also have a unique feature regarding distributions. As income is generated within the S corporation, the shareholders of the S corporation are allowed to pay out that income. They can accomplish payouts through compensation and/or distributions. Distributions are allowable to the extent of AAA in the organization. If there are excess distributions above AAA, the excess will be considered income to the shareholder.

Distributions must be paid out proportionately to stock ownership. If there are two shareholders owning 50/50, and one shareholder gets a $10,000 distribution, the other shareholder must receive $10,000 also. There cannot be unequal distributions with an S corporation. The question becomes when this has to be done (e.g., within the calendar year January 1st-December 31st) or can there be a follow-up distribution made in January to equalize the distributions? My advice: those distributions should be made equitable during the calendar year or the fiscal year of the company. What needs to be reported on the K-1 for each shareholder is the amount of distributions they have received during the year.

The IRS has made it a practice of trying to match up the distributions in regard to stock ownership.

**ESOPs and S corporations.** A tax act looked at favorably for S corporations was the Small Business Job Protection Act of 1996. The act did allow certain exempt organizations, including employee stock ownership plans or ESOPs to be S corporation shareholders. The real advantage of having an ESOP as an S corporation for shareholders is both the corporation and the ESOP are exempt from federal income tax.

**Partnerships.** The fourth choice of entity is something called the limited liability partnership (LLP). Today, many states have passed laws giving partners the same blanket liability protection as LLC members; therefore, the liability protection is the same. However, the general partner of a partnership is not limited to liability.

**C corporation.** A corporation has always been the preferred form of business because of liability protection provided through the statutes to the shareholders. In most C corporations, no stockholder has liability for any corporate debt or obligation. We often take a look at C corporation structure for those entities just beginning because the expectation of lower profits in earlier years allows the entity to take advantage of lower tax rates in those formative years. We evaluated a plumbing subcontractor and anticipated taxable income would be less than $50,000 for 3 years. These lower profits suggested the C corporation form would outweigh the other entity options.

Advantages of C corporation are as follows:
- Limited liability for shareholders to the extent of their investment;
- Ease of issuing stock may help address raising capital as you review growth opportunities;
- You can have multiple classes of stock;
- A sale of any Section 1244 stock may allow ordinary loss treatment, which is beneficial against other ordinary income, like salary or investment income; and
- Taxable income up to $50,000 is taxed at low 15 percent tax rates, which allows you
to retain earnings for investing in your company for future growth.

Disadvantages of C corporations are:

- Any capital gain income is taxed at the ordinary corporate rates and not the lower capital gain rates, like with individuals;
- Income is double taxed once at the corporate level and then at the individual level when it is paid out as compensation to shareholders; and
- The losses are not passed through to shareholders, so tax planning is complex as you try to utilize the lower corporate rates versus higher individual rates.

Other tax issues regarding choice of entity

Small corporation exemption. One of the actions with the 1997 Taxpayer Relief Act included an exemption for small corporations from AMT. This is very advantageous to smaller general and sub-contractors who qualify and can use the cash and/or completed contract method of accounting to recognize taxable income. The key criteria is the contractor has average revenue below $7.5M over a three-year time period.

Small corporation definition of “gross receipts.” One key criterion in determining the small corporation gross receipts is the aggregation rules of Section 1563A. This often becomes a complex issue for contractors since most are involved in a number of entities, such as equipment leasing and/or real estate rental activities because they own land and buildings for commercial and/or residential rental. The overall "gross receipts" definition takes into account all revenue from all entities. Today, bank financing is determined on “global cash flow,” so many construction companies with multiple types of businesses are already being asked to provide this information.

For aggregation purposes "controlled groups" are affiliated companies in either a parent sub-relationship (and the parent owns more than 50 percent), or a brother-sister relationship (5 or fewer shareholders own at least 80 percent of the vote and value of each company). Once a corporation exceeds the average annual gross receipts test and therefore is not eligible for the exemption there is no opportunity for it to regain the exemption in future years.

Rental activities. Many contractors also have numerous rental activities as a side-line business. In these cases, the net income from the rental activities is typically non-passive trade or business income, but they are subject to the passive activity rules under Section 1.469-4. Most contractors have the option to elect to be treated as a real estate professional, and therefore any losses from the activity are treated as non-passive and can be deducted against their other rental activity. In this case, most rental activities are probably owned in an LLC entity. Again, it is worthwhile to note, some states do not recognize this form of choice of entity.

Multi-state Issues. In Wisconsin, we have numerous contractors working across borders in Minnesota, Illinois, and Michigan. The prevalent issue is to reduce the amount of reporting. An example is an S corporation with three shareholders doing work in Illinois while they are a Wisconsin corporation. We have the S corporation report in both states via apportionment but do not have the three shareholders each report in those states. Tax law allows us to have composite tax reporting where the corporation is filing in the foreign state (i.e., Illinois) on behalf of the three shareholders who are residents of Wisconsin. This can be a very effective planning and reporting exercise, as you look at where your contractor is going to be performing work. It is a very complex issue and needs to be analyzed before you make a recommendation on what choice of entity your construction company client should be organized as.

Entity conversions. There is an opportunity to convert from one entity choice to another, and a sole proprietor has this flexibility. You can convert from a sole proprietorship to a corporation or an LLC. You accomplish this by electing a Section 351 exchange. This action is recommended when taxable income has increased and you want to take advantage of lower rates in a C corporation to avoid the self-employment tax on the taxable income you are generating as a sole proprietor. Again, the sole proprietor income, as with LLC and LLP income, will be subject to self-employment tax.
**Conversion of C to S corporation status.** One unique feature that catches tax advisors on occasion is a conversion of a C corporation to an S corporation. The real obstacle is the built-in gains tax (BIGT), which is a tax assessed on a corporation on the net appreciation of assets realized before the S corporation election is effective. In the past, any assets sold within that 10-year time period after electing S status had to pay built-in gains tax at 35 percent. The new rules shortened that time period to five years for BIGT assets sold in 2011. This is very important when working with contractors, because their work in process on a percentage of completion basis and selling fixed assets during this time period will result in built-in gains tax. It is imperative you work with a knowledgeable tax advisor before converting from C corporation to S status to watch this tax trap.

**Life cycle and entity type choices.** From our experience advising construction companies in the start-up stage, one of their main obstacles is a shortage of cash. Our entity choice analysis would evaluate the ownership structure and the future succession plan for those current owners to exit the company. In this case, a C corporation entity with no restrictions on raising capital via new investors may be a better strategy versus an S corporation with fewer eligible shareholder choices.

In the growth stage of the life cycle, an owner is usually experiencing higher profits. At that point, decisions need to be made whether or not converting to an S corporation, with its single tax, is the best vehicle to retain earnings facilitating future growth.

As a construction company enters maturity with lower margins and potential losses, the question becomes whether the C corporation is a better entity choice to capture some of those losses or an S corporation, where the losses would be passed to the actual shareholders? This is a timely point to again evaluate choice of entity.

And finally, when an organization finds itself in a stage of decline and is trying to renew itself, it may be important to bring on new ownership and accomplish it easily. The key type of ownership may be a C corporation with more flexibility with ownership.

**Conclusion**

As a tax advisor in the construction industry, it’s apparent there are numerous opportunities to review the choice of entity. It is important to understand where the majority of the work will be generated and at what revenue volume. However, once you have made the original decision and your contractor client has performed work in that choice of entity, it is a very worthwhile exercise to re-evaluate the real decision factors. Timely re-evaluation of choice of entity will enhance the shareholder value of your contractor client.