Choice of Entity Selection

An Accounting Perspective

Presented by
Jerry Henderson, CCIFP, CPA
National Industry Partner
BKD, LLP

Tax considerations for choice of entity selection

Common choices of entity

- Corporation
  - Regular or "C" corporation
  - "S" corporation
- Limited Liability Entity
  - LLC
  - LLP
- Partnership
- Sole Proprietorship

C Corporation Fundamentals

- Pays tax directly at federal & state levels
- Dividends paid to individuals are taxed
- Stockholders' basis is what they paid for stock. Gain computed on difference between price paid and selling price.
- Stock held for greater than a year in C corporation is taxed at long-term capital gains rates (currently 15% federal)

C Corporation Fundamentals

- Stock held less than a year taxed at short-term capital gains rate (same as regular income tax rate)
- Dividends also taxed at 15% federal rate
- Can be owned by any type of stockholder (e.g. individual, trust, other corporations, foreign nationals, any type of retirement plan, etc.)
- Can have more than one class of stock (e.g. Preferred or Common; Series A vs. Series B)
- Special loss rules apply to Section 1244 stock

S Corporation Fundamentals

- Legally, one-in-the-same as any other corporation
- For tax purposes, special election to be treated as a subchapter S corporation
- Earnings are passed through the shareholders via a K-1. Generally, S corporation pays no tax (some differences at state level)
- Basis in stock increases for earnings taxed and not distributed
- S corporations must generally make distributions to shareholders to help them pay tax liability

S Corporation Fundamentals

- Limitations on the types of shareholders an S corporation can have (e.g. can't be a foreigner living abroad, a C corporation or a partnership)
- S corporations may only have one class of stock, but generally voting and non-voting have been deemed to be OK
- Earnings and gains taxed only once – at shareholder level, so while rates can be higher than corporate rates, there is only one level of tax

Limited Liability Entity Fundamentals

- Most aren't aware that an LLE can be taxed as either a corporation or a partnership, but taxed as a partnership by default
- Similar to an S corporation because of "pass-thru" status but more flexibility than an S corporation
- Flexibility in types of ownership and allocation of tax attributes
- This leads to more complication than exists for an S corporation due to unique partnership issues (inside/outside basis issues, Section 754 elections, 704(b) allocations, etc.)

Limited Liability Entity Fundamentals

- Very few restrictions on who can own an LLC interest
- One level of tax – at "member" or investor level
- Can have multiple different classes or types of ownership interest
- Single member LLC is a "disregarded" tax entity.

Partnership Fundamentals

- Generally the same as LLE fundamentals
- Partners' basis is increased for debt of the partnership
- Character of income by partnership typically flows through to the partner

Sole Proprietor Fundamentals

- No legal entity
- Taxed on the individual's 1040 via a schedule C
- No separation between the "business" and the individual
- Difficult in many circumstances to define the business beyond a collection of assets

Other matters

- ESOPS
- Joint Ventures
- Limited Partnerships
- Financial Reporting matters

Legal Structures of Construction Companies

Presented by
Michael A. Ito
Vice President
North American Specialty Insurance Company

Statistics – NAS Surety

- 3,500 Premium Producing Accounts
- Sample includes contractors with annual revenues from $1MM to $100MM
- Numbers track the main operating company

Statistics – NAS Surety

- Sub S Corps
  - The Largest percentage of our book (51%)
  - By far the most common choice for contractors starting in business from 1986-2002 (3x that of C-corps)

Statistics – NAS Surety

- C Corporations
  - The 2nd largest percentage of our book (30%)
  - For contractors who started in business prior to 1986, around 50% remained C Corps, around 50% converted at some point to S Corps
  - Rarely chosen for new business today. For businesses starting over the last 10 years, only a minimal percentage (less than 1%) were C-Corps.

Statistics – NAS Surety

- LLCs
  - The 3rd largest percentage of our book
  - The fastest growing legal structure. For contractors starting in the past 10 years, we are seeing around a 50/50 split between S-Corps and LLCs
  - Clearly the most commonly used structure for real estate investments, holdings.

Taxes – Surety Perspective

- C - Corporation
  - Corporation pays taxes currently due and accrues a deferred tax item to reflect differences in revenue and cost recognition between the books for financials and taxes
  - Simple from a surety analysis standpoint

Taxes – Surety Perspective

- Pass Through Entities (S-Corps, LLCs and Partnerships)
  - Taxes are pass throughs to the individual(s)
  - Entity does not pay current taxes and does not accrue a deferred tax item.
  - Can cause the Financial Statement to be significantly overstatement if liabilities are not analyzed.
  - 2 Liabilities must be determined – Current and Deferred

Analysis of Pass Through Liabilities

- Current Tax Liability
  - Taxes owed for current year's operations
  - Determined based on the tax method contractor uses, not the financial statement method
  - Concern is what the contractor will withdraw after the FYE to pay 4/15 tax bill.
  - Current liability on the analysis.

Analysis of Pass Through Liabilities

- Deferred Tax Liability
  - Tax Returns (1120S, 1065) or CPA can be used to determine tax method.
  - Primary concern is Deferred Tax Liability due to income recognition differences, not depreciation recognition differences.
  - 2 most common tax methods for recognizing revenue – cash or completed contract.

Analysis of Pass Through Liabilities

- Cash Method
  - Deferred Income is Future Income less Future Expenses:

    1. (Accounts Receivable + Underbillings) – (Accounts Payable + Overbillings + Accruals)

    2. Multiplied by a marginal tax rate (30%)

Analysis of Pass Through Liabilities

- Completed Contract Method
  - Deferred Income is the Gross Profit recognized on balance sheet but not on tax return

    1. Gross Profit earned to date on open jobs
    2. Multiplied by a marginal tax rate (30%)

Indemnity

- Corporations
  - "C" and "S" Corps treated the same
  - President is general accepted as having the power to sign an Indemnity Agreement and bind the Corporation
  - Other officers may be empowered to sign and bind. Usually look for a copy of the corporate by-law or a specific resolution.
  - Signature of one corporate officer is sufficient

Indemnity

- Limited Liability Company (LLC)
  - Owners are "members"
  - The "Managing" member is normally authorized to bind the LLC on an Indemnity Agreement but sometimes a "Manager" or a "Chief Executive" has this power.
  - Generally want to review the Articles of Organization and/or the Operating Agreement.

Indemnity

- Partnerships
  - Rights and responsibilities of the partners are spelled out in a Partnership Agreement.
  - Without the Partnership Agreement, signatures of all partners must be obtained in order to be certain indemnity is complete
  - 2 basic forms – General and Limited

Indemnity

- General Partnerships
  - All partners are equally responsible and liable for debts.
  - All partners should sign, although often one General Partner can sign. (Partnership Agreement)

Indemnity

- Limited Partnerships
  - Typically have a General Partner with the power to bind the partnership and limited partners who have limited rights.
  - Most commonly a General Partner who manages business affairs while Limited Partners provide investment capital.
  - If a Limited Partner signs on behalf of the partnership, proof of ability is needed.

Indemnity

- Joint Ventures
  - Most sureties have Joint Venture Language
  - Surety Association of America Form 1 can also be used.
  - Review of the JV's pre-bid agreement and/or the JV agreement is common.

Indemnity

- Trusts
  - It is normally within the legal right of the Trustee(s) of the Trust to sign indemnity Agreements.
  - To verify Trustee has the power to bind the trust, obtain a copy of the trust document
  - As a general rule, irrevocable Trusts cannot indemnify.

QUESTIONS???