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Harder than it looks

Changing business structures calls for careful planning

Contractors who are starting new businesses must be careful when choosing the form of ownership, or business structure, for their businesses. Once a form is chosen, the business may operate in that form for years. In fact, the contractor may never need to move to another structure. To leverage financial opportunities, take advantage of tax breaks, and limit their legal and financial liability, however, established contractors may eventually want to switch structures.

Yet changing your ownership form isn't as easy as changing your hat. Each option comes with its own set of pros, cons and tax consequences. Here's a look at the most common choices.

Sole proprietorships

The simplest form of doing business is a sole proprietorship. It's the easiest to set up and the easiest to shut down. One owner has control and ownership and reports all income or losses from the business on his or her personal tax return.

The elephant in the room is that sole proprietors have unlimited liability and are legally responsible for all debts and lawsuits against their businesses — putting both business and personal assets at risk. By its very nature, the construction industry involves substantial risk, so most contractors prefer a business structure that can insulate them from potential liability.

Partnerships

In a partnership, two or more people own the business. A partnership agreement spells out how decisions will be made, profits, losses and liabilities shared, and disputes resolved, and how partners can be bought out. It also outlines how the partnership will be dissolved, if needed.

Although the partnership itself doesn't pay federal income taxes, it must file an informational return. Individual partners then report their share of profits and losses on their personal tax returns. As with sole proprietorships, the partners of a general partnership are generally liable for the debts of the partnership and are thus exposed to substantial risk.

A limited partnership protects the limited partners from personal liability for negligent acts committed by other partners and employees not under their direct control. A variation is the limited liability partnership (LLP). Some states restrict this type of partnership to professionals, such as lawyers and accountants.

Corporations

A corporation is an independent legal entity, separate from the people who own, control and manage it. Contractors often choose this business structure because it insulates them from personal liability — only the business's assets are at risk. This generally means owners need not worry about creditors seizing their personal assets.

How the corporation is taxed depends on its type:

C corporation. Also known as regular corporations, C corporations have generally fallen out of favor, primarily because companies set up

in this fashion face double taxation — profits are taxed at the corporate level and again when distributed to shareholders as a dividend or upon liquidation of the business.

S corporation. Many construction companies choose to form an S corporation because it avoids that double taxation. Individual shareholders are taxed directly for the profits and losses of the company, and distributions are based on ownership percentages. Generally, the corporation doesn't pay any tax.

Limited liability companies (LLCs)

The LLC combines the limited personal liability feature of a corporation with the tax advantages of a partnership, sole proprietorship or S corporation. Profits and losses are typically passed through the company to its owners — who are called members. In addition, members don't have to allocate income proportionately to ownership, as they do in an S corporation.

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There's a hitch, though: LLCs aren't governed by the same rules in all states. This form of ownership becomes especially tricky for contractors who do business in more than one state and must deal with multiple states' LLC rules. For example, the protection from liability in the state where a contractor sets up a business might not be available when he or she crosses a state line to work.

The LLC is more flexible because you can generally switch to a corporation down the road without dire consequences, though a switch in the opposite direction may bring with it a prohibitively large tax.

Avoid unpleasant surprises

This article only scratches the surface of the many complexities of choosing or changing business structures. Clearly, this is a decision that calls for an objective assessment of your construction company's business position, a thorough analysis of its federal and state tax issues, and a deep understanding of the legal ramifications of each structure.

To avoid unnecessary complications and negative consequences, consult your CPA and lawyer before making any moves.

5 things to consider when choosing a business structure

Suppose your largest competitor runs his contracting business as a limited liability company (LLC). Lately, he's been bragging about how his business is enjoying unprecedented profit. Meanwhile, you're running your company as an S corporation and are starting to wonder whether you should switch to an LLC or another entity choice. Here are some things to consider before making any leap to a new structure:

1. The amount of liability you're willing to assume. Some forms of ownership don't protect your personal assets from business debts.

2. How much structure you want. A sole proprietorship has little structure — any corporation will have much more.

3. State regulations. A corporation having business locations in multiple states may form a business entity in a single state and then "qualify to do business" in other states. To benefit from the laws of any state and obtain permission to conduct business, companies must register, pay annual fees and file annual reports for each state in which they operate. In addition, some states don't permit the formation of LLCs for certain businesses.

4. Cost. Simple ownership structures, such as proprietorships, are much less expensive to establish and maintain than corporations.

5. Tax consequences. Ask your CPA to help you analyze what ownership form is most beneficial for your individual circumstances and whether you can switch an existing business without tax consequences.

Retainage: Necessary practice or unfair penalty?

Imagine a doctor's response if patients said they wouldn't pay the full cost of their annual physicals until they were convinced of their good health. The doctor would probably see it as a joke.

Yet construction project owners do this all the time, withholding a percentage of each progress payment made to contractors to, if necessary, finance completion or correct a defaulting contractor's work. And while owners contend that retainage is, and always has been, a necessary business practice, many (if not most) contractors see it as an unfair penalty.

Lobbying for change

Retainage percentages vary from state to state, as do the timelines on which those funds are released. Contractors generally prefer that owners release all or a significant part of retainage when a project is 50% complete, but many owners hold the retainage until a project is done.

In response, several construction associations have lobbied state legislators to limit retainage amounts. Many states responded by capping retainage at anywhere from 5% to 10% of the contract price. In addition, some states now require that retainage funds be held in interest-bearing escrow accounts.

Owners contend they have no obligation to pay interest on retainage, as the withheld funds are theirs until they're contractually required to release the money. Contractors, on the other hand, maintain that retainage provides zero-interest financing for projects and that, in an industry where the typical profit margin is between 2% and 5%, retention of up to 10% is quite a burden.

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Finding a better way

Some in the industry have suggested depending on surety bonds to replace or compensate for limits in retainage. While bonding and retainage are financial tools designed to ensure project completion, they serve different purposes. A surety bond that would be used as a substitute for retainage wouldn't differ from traditional surety bonds. Surety bonds are more appealing to contractors because they don't involve holding back progress payments as leverage to prevent default.

Opponents counter that surety bonds don't give contractors an equal incentive to complete projects. While retainage provides readily available funds in case a contractor fails to finish a job, they contend that a surety bond isn't a sure thing if a project goes sour. In fact, a surety bond may not pay out until after extensive litigation. As a result, project completion may be long delayed.

Another suggestion is to increase or improve periodic inspections of job sites to replace retainage. These

enhanced inspections would help determine whether work is being completed in compliance with contract documents.

Driving a hard bargain

The good news is: You have some leverage in setting the ground rules for retainage and negotiating favorable contracts. For starters, try quoting two prices — one if retainage is held, the other if it's not. Doing so may help the owner better appreciate the financial burden retainage can impose.

Also consider stipulating that retainage be handled consistently throughout a project rather than differently at various job stages. You might also propose a fair rate of interest on all retained funds and contract language allowing interest to accrue on funds not released in a timely manner.

The times they are a-changin'

New risk-assessment standards will affect your annual audit

If yours is a privately held construction business, get ready: Your CPA will be taking a closer look at your 2007 year end financial statements. But don't blame your accountant! In March 2006, the American Institute of Certified Public Accountants (AICPA) issued eight new auditing standards, collectively referred to as the "risk-assessment standards."

The new risk-assessment standards are the most significant change to auditing in the last 30 years, and they affect CPAs and contractors alike.

What's so different?

The biggest change is that your CPA will be paying more attention to your internal culture and operations to assess the risk of errors or fraud in your financial statements. This will require him or her to examine the controls you have in place by:

- Discussing certain issues with your employees (such as key controls and staff functions);
- Considering regulations and other external factors that affect your business, and
- Studying your construction company's governance, objectives and strategies.

In the past, auditors were required to have only a basic understanding of an organization's internal controls.

How will this affect you?

Because of the additional time your CPA is now required to spend researching your company, expect the audit to take more time and, in most cases, be more expensive. Expect your CPA to contact you to

schedule required interim fieldwork before year end. Although the new standards place most of the work on the auditor's plate, you'll probably need to devote more time to the auditing process as well. That's because the standards require your auditor to ask you for information and documentation that you didn't

have to provide in the past. For example, your CPA will now need to find out how you:

- Enter transactions into your company's financial records,
- Initiate, authorize, record and process transactions in the general ledger, and
- Prepare financial statements and related disclosures.

Moreover, you'll need to inform your CPA how your company initiates and records recurring and nonrecurring adjustments for journal entries to its financial statements. And you'll have to provide your auditor with documentation for every relevant internal control procedure and financial transaction.

In addition, you'll need to give the CPA information and supporting documentation about your company's objectives, strategies and business goals; how you measure and review financial performance; and how you select and apply accounting principles.

Is there an upside?

While no one looks forward to devoting more time and resources to an audit, there may be an upside to this arduous process: By putting your construction company under a microscope, your auditor will be in a better position to recommend ways to rein in risk, prevent fraud and benchmark your business practices against those of competitors.

To ensure the process goes smoothly, meet with your CPA well before your annual audit to pinpoint exactly what documentation you'll need to gather and to discuss how you can work together to minimize any additional costs.

Construction projects go high-tech with GPS

The use of global positioning system (GPS) technology in construction is growing as contractors learn how to leverage its capabilities for tracking vehicles and equipment, dispatching crews and supplies, reducing theft, and mapping job sites.

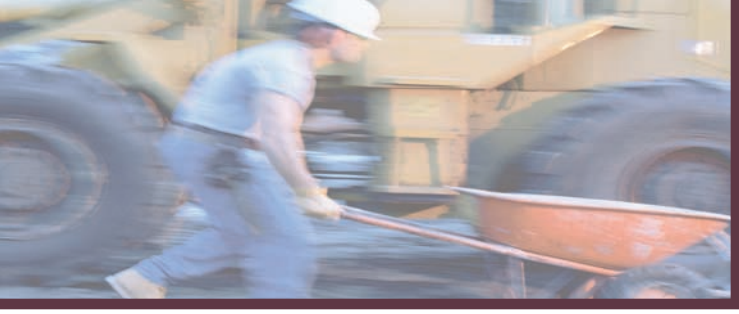
From a fleet management perspective, GPS technology allows you to view the positions of equipment and vehicles at all times. If need be, you can monitor your entire fleet or just key pieces of equipment. Satellite-based technology allows dispatchers to track movements on a visual mapping system, helping crews determine the most efficient routes to job sites. If crews need more equipment, you can locate the nearest equipment instantly and quickly dispatch it to the site.

Along the same lines, you can place GPS locator tags on materials to track their location in real time. You'll always know how much you have in inventory and whether materials are going to the right sites as scheduled. In the event a crew's supplies fall short, you can map and route additional deliveries to job sites quickly and efficiently.

Taking GPS technology a step further, you can create virtual fences around equipment, vehicles, materials or employees that alert authorities if anything or anyone moves outside designated areas. The system will send a real-time signal to an alarm company, which can then alert police. If thieves do manage to swipe your equipment, authorities may be able to track the stolen goods electronically using the GPS system.

There are many levels of GPS technology and what you pay will depend on the product features you're considering. In general, typical state-of-the-art systems cost about $80,000, but contractors who use them maintain that the gains they realize pay for the purchase in no time.

Contractors are just beginning to realize how GPS technology can benefit their businesses. From working smarter and more efficiently to better managing rogue employees or missing equipment, GPS can help you operate your business more efficiently and protect costly equipment and inventory.



5 tips for avoiding tax audit triggers

Paying income taxes is painful enough without the specter of penalties and interest. But that's just what you'll incur if an IRS audit reveals you broke the rules. Here are five tips for avoiding those audit triggers that can tax your construction company in more ways than one:

1. Report all business income. You must pay taxes on income received for all work, including side jobs and work paid for in cash. This includes work done in exchange for credit on a bill and for goods or services in a barter exchange. Even if you don't receive a Form 1099 or a W-2, you must report all income.

2. Watch business deductions. To be deductible, business expenses must be "ordinary" *and* "necessary." Both conditions must be met. Ordinary and necessary expenses that may be deducted in the year incurred include utilities, car and truck expenses, employee salaries, trade association dues, supplies, continuing education and small tools expected to last one year or less.

You can't deduct personal expenses, such as clothing that can be worn off the job site, fines and penalties, and the nonbusiness use of vehicles or computers. Other expenses, including certain meal and entertainment expenses, may be at least partially deductible.

3. Apportion expenses consistently. Construction projects often straddle two or more tax years. When they do, you need to determine whether you should recognize income and expenses proportionately or wait until completion. It depends on whether you operate on the cash or accrual method of accounting, or a long-term contract method. With any method, you must be consistent and there must be a matching of income and expenses. Don't deduct certain expenses now if you plan to wait until next year to account for revenues.

4. Follow standards of reasonable compensation. If you operate your construction business as a corporation, make sure you pay any shareholders who work for the company within the standards of "reasonable compensation." What's considered reasonable is subjective, but the basic rule is that shareholders should pay themselves what they would pay others to do their jobs.

In an S corporation, the IRS may reclassify excessive distributions as wages, making the shareholders liable for payroll taxes on the total amount. In a C corporation, the IRS may consider a high salary as dividend income and deny deductions for any associated compensation expenses.

5. Don't bill personal expenses to the company. The IRS is on the lookout for contractors who improperly bill their companies for the cost of making improvements to their personal residences or other real estate to reduce their tax liability. To detect improperly billed personal expenses, auditors pay close attention to contracts, billings, invoices, completion notices and other related paperwork.

Following these five tips will go a long way toward reducing your chances of being audited, but there are no guarantees. If you're selected for an audit, contact your CPA immediately. He or she can help make the IRS encounter less painful by handling most of the interaction, determining what information is appropriate to provide and making sure the process is as efficient as possible.