

Pros and Cons of Incorporating a California Construction Business

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Please note that this article is only intended to provide some general educational information regarding the pros and cons of incorporating a general or specialty licensed construction business in California. Deciding whether or not to incorporate your business has significant legal and tax implications and is a decision you should make only after reviewing the current laws, facts, and circumstances affecting your business with your attorney and certified professional accountant.

THE COST OF INCORPORATING

There are many things to consider before deciding whether or not to incorporate your construction business. A good place to start is by considering whether or not your business can afford the cost of incorporating. The initial cost of incorporating a new business can vary from several hundred dollars to several thousand dollars. The least expensive way to incorporate your business is to purchase a "How To" book and do it yourself, or hire a low cost paralegal service to assist you with the completion and filing of the paper work. However, saving money initially to set up your corporation, may cost you money in the long run. The problem with doing it yourself, using a paralegal forms service, or anyone other than an experienced construction law attorney, is that your chances of making a critical mistake increase when you don't hire someone with the right experience for the job. In other words, doing it yourself, or using a low cost service may have an initial upside of saving you some money, but it may also have a potential down side of destroying your business and even landing you in jail.

CONTRACTING WITHOUT A LICENSE IS A MISDEMEANOR

An example of an incorporation mistake which could destroy your business and land you in jail is setting up a corporation, but neglecting to apply and qualify your corporation for a separate contractor's license from the Contractors State License Board ("CSLB"). With very limited exceptions, unless your corporation is properly licensed at all times during the performance of a construction project, you and your corporation may be guilty of contracting without a license, which is a misdemeanor punishable by a fine of up to \$1,000.00 and six months in jail. In addition to running the risk of going to jail for contracting without a license, your corporation will not be able to enforce payment for construction services it performed without a license, and it may be forced to return any money it received for construction services it performed without a license. For more information on the adverse consequences of contracting without a license, see the article in this website entitled "*Potential Ramifications for Unlicensed Contractors in California.*"

HOW TO ESTIMATE THE COST OF INCORPORATING YOUR BUSINESS

To determine whether or not you can afford to set up a corporation ask your accountant and your attorney to estimate the costs and tax implications associated with forming your corporation. Specifically, ask your accountant to estimate the minimum annual taxes your corporation will have to pay in local, state, and federal taxes. Unlike businesses operated as sole proprietorships, California corporations pay an annual minimum state tax whether or not they make a profit. Additionally, forming a corporation may put you in the unenviable situation of having your income taxed twice because your corporation will pay a tax on earnings, and you will also pay income taxes on the wages and dividends you receive from your corporation. Ask your accountant if you can avoid the possibility of double taxation by setting your corporation up as a "Sub S" corporation.

OPERATING CAPITAL

Another cost to consider is the amount of money the shareholders will have to contribute to the corporation for working capital. With advice from your accountant and your attorney you can determine how much money (capital) your corporation will need for business start up, operating expenses, and to comply with minimum capital requirements. For instance, the CSLB requires that corporations applying for a contractor's license have a minimum of \$2500.00 in capital. A corporation's capital is what the shareholders pay the corporation in exchange for shares of stock. In addition to the minimum amount required by law, you and your accountant should estimate the amount of operating capital your corporation will need to reach a point where you expect your corporation to begin producing enough income to meet its expenses (working capital).

ATTORNEYS' FEES AND COSTS

With your attorney determine what legal fees and costs you will incur to form your corporation. In addition to charging for their time to prepare your corporate documents, attorneys will also require that you pay state filing fees, and the cost for your initial corporate supplies. State fees include charges to reserve your corporation's name and to file your corporation's articles of incorporation with the Secretary of State, and to register the sale of your corporation's stock with the Department of Corporations.

The initial corporate supplies usually include a corporate seal, stock certificates, a stock ledger to keep track of the corporation's stock transactions, and a 3-ring binder to keep all your corporate records together and organized. In addition to the basic documents your attorney will draft to set up your corporation (articles of incorporation, bylaws, initial meeting minutes, and corporate resolutions), your attorney may also recommend that your corporation restrict the transfer of shares of stock with a buy-sell agreement. Buy-sell agreements restrict the sale of stock by existing shareholders so that before a new shareholder can purchase any of the corporation's outstanding shares of stock, the existing shareholders and the corporation get a first right of refusal to purchase the stock. Your attorney may also recommend the drafting of employment contracts for key employees, and securing personal loans you make to your corporation with promissory notes and security agreements. To complete the formation of your corporation your attorney should help you organize and complete an initial corporate meeting where the corporation will sell stock, nominate and elect directors and officers, authorize the

corporation to set up bank accounts, make the elections for tax status determination for the state and the IRS (sub-chapter "S" election), select a principal business location, and set up other essential functions the corporation will need in order to begin business operations.

CORPORATE FORMALITIES

Once your corporation is formed, your attorney should provide you with written instructions advising how to comply with corporate filing and record keeping formalities. For instance, your corporation will have to file an annual *Domestic Stock Statement* with the California Secretary of State, conduct an annual meeting of stockholders, keep annual meeting minutes, and file tax returns. Please keep in mind that the failure to adhere to these and other routine corporate formalities can result in the loss of the primary benefit of forming a corporation, protection from personal liability for business expenses.

OBTAINING A CONTRACTORS' LICENSE FOR YOUR CORPORATION

Another expense to estimate for the formation of your corporation is the cost for your corporation to obtain a California state contractor's license. You can generally get this information from your attorney or a contractors' license service. Also ask how long it takes the license board to process the license applications because until and unless your corporation obtains a contractor's license it cannot legally engage in the contracting business. Once you have obtained estimates for professional legal and accounting fees, state filing fees, licensing costs, and initial business capital, you should have a good estimate of what it will cost to incorporate your business.

THE BENEFITS OF INCORPORATING

In all likelihood, the total cost estimates to incorporate your construction business and cover the increased taxes and associated corporate expenses will be significant. The time to prepare a business plan, obtain estimates for professional services, retain professionals and complete the formation of, and obtain a license for your corporation, could easily take six months. So why bother? What are the benefits of incorporating that justify incurring the expenses and the added business complexities of maintaining a corporation?

Some of the principal benefits of incorporating your business are: (1) the ability to separate and protect your personal assets from your business' potential liabilities and financial losses; (2) creating a more professional business image; (3) the ability to raise capital by selling shares of corporate stock; (3) creating a business entity which may continue to exist beyond the death of its founders; (4) facilitating the ability of the business to attract and retain key employees; (5) enhancing your ability to sell your business; and (6) creating the opportunity to bring talent and expertise to your business with a professional board of directors.

CONSTRUCTION IS A RISKY BUSINESS

Construction businesses have a high failure rate. Even the building of a relatively small structure generally requires coordination and cooperation between property owners, construction lenders, architects, engineers, municipal building departments, building inspectors, general contractors, subcontractors, trades people, insurance companies, equipment vendors, and building material suppliers. From start to finish, a typical construction project is under tremendous economic pressure because of the construction industry's general practice of awarding contracts to the lowest bidder. Unfortunately, sometimes the lowest bidder is the company that overlooked an expense and produced a low bid as a result of a bidding mistake. Other times a project will have one or more participants who won bids because they cut corners to lower their bid price. As a result, progress on the job is often disrupted by the failure of one or more participants in the construction process to perform as anticipated, or by unexpectedly long periods of bad weather. Whatever the cause, construction delays have the potential to negatively impact the financial status of all the participants in the project. So, given the risky nature of the construction business, a wise business owner will take steps to separate and protect his or her personal assets from exposure to those risks. Incorporating your construction business together with the right insurance coverage can provide a liability shield to protect your personal assets and more than justify the cost and time it takes to incorporate your business.

CREATING A PROFESSIONAL IMAGE

Incorporating your business evidences a certain degree of financial ability and business sophistication. Anyone who has been through the process of incorporating their own business knows what it takes to set up and successfully manage a corporation. Therefore, your clients and potential clients may consider incorporated businesses to have more credibility, reliability, and professionalism than unincorporated businesses. To enhance your corporate image and comply with CSLB regulations make sure that all your corporation's contracts, invoices, letterheads, advertising materials, business cards, etc., show the name and license number of your corporation exactly as it appears in the Contractors' License Board's records of licensed contractors. Using a business name other than the name listed with the CSLB may subject you to charge of contracting without a license. Go to <http://www.cslb.ca.gov/> to check your listing with the CSLB.

RAISING MONEY BY SELLING SHARES OF STOCK

Unless your corporation is listed as a publicly traded company like General Motors, you cannot advertise the sale of your corporation's stock to the public and the number of shareholders for your corporation will be limited. Confirm the actual number of shareholders and restrictions on the sale of your corporation's stock with your attorney. Generally speaking, you can only sell your corporation's stock to people you know personally or have a pre-existing business relationship with such as family, friends, business associates, and employees. The sale of stock in your corporation should only be done with the advice of an attorney to make sure that your investors are properly informed regarding the restrictions associated with your corporation's stock and to insure that proper records are kept of all your corporation's stock transactions. Keep in mind that shareholders nominate and elect the corporate directors. The corporate directors then nominate and elect the corporate officers who run the day to day operations of the corporation in accordance with the corporation's bylaws and direction as provided by the corporation's board of

directors. Elections of directors are determined by a majority vote. Therefore, the person or persons who control the majority of the corporation's stock, control the corporation.

A CORPORATION HAS AN UNLIMITED LIFE

Unlike you or me, a corporation does not have a limited life span. Theoretically, a corporation can go on forever. That means that you can transfer the ownership of your corporation by leaving your corporate stock to your heirs, or selling your stock. In either event, your corporation can continue long after you. This also allows you the option of increasing your corporation's chance of retaining key employees by making them attractive offers to purchase corporate stock, or by including corporate stock in their benefit's package. Before you take the step of transferring or selling stock to your employees, be sure and consult with your accounting and legal professionals. For instance, when you sell or transfer corporate stock your shareholders should be bound by a buy-sell agreement which restricts the sale of the corporation's stock so that you and/or the other shareholders, and the corporation can control the transfer or sale of corporate stock.

BOARD OF DIRECTORS

Once your business is incorporated, you may be able to recruit other successful professionals to serve as members of your corporation's board of directors. These individuals can bring prestige, knowledge, business connections, and skills which may enhance your corporation's profitability and allow you to retire in style.

PLANNING YOUR TRANSITION

No matter how successful your corporation becomes, or how much you enjoy working, at some point either voluntarily or not, you will stop working. Ideally, with the assistance of your financial and legal consultants, you will plan ahead for that day so that you and your family can maximize the financial benefits you receive from having worked hard to establish and develop a successful corporate construction business.

If you have any questions or comments regarding this article, please do not hesitate to contact Scott Green at Green & Campbell, LLP.

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