Texas Home Builder Business Structuring

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This paper examines legal business entities utilized by Texas home builders. Data was obtained from 26,663 registered builders through the Texas Residential Construction Commission (TRCC). This information, dating from 2004 through 2005, reveals that 50% of residential constructors are organized as sole proprietorships. These findings indicate an overexposure of home builders to the risk of unlimited liability. This article also provides an overview of market trends related to home building, an explanation of common types of business structures used in the Texas residential construction industry, a description the newly formed TRCC, and a discussion and interpretation of results. The initial findings from this database will serve as a benchmark from which a longitudinal study can be conducted to identify trends in business structuring.

Keywords: Home Building, Residential Construction, Legal Entities, Business Structuring

Introduction

This study examines trends in ownership structures of homebuilders in Texas. Data was obtained through the Texas Residential Construction Commission (TRCC) to determine the most common types of legal entities used in residential construction. A total of 26,663 registered homebuilders and remodelers, from 2004 through 2005, provided the TRCC with information about their legal business structuring. Recent legislation has required homebuilders in the state to register with the TRCC and provide details about their legal ownership structures. Texas A&M has the unique opportunity to work with the TRCC in creating and revising warranty standards for residential construction and gathering and analyzing data related to registered homebuilders and construction projects. As a result of data analysis, trends related to Texas homebuilders and the homebuilding industry will be able to be identified. Data used for this study is the first of its kind in Texas and provides a unique glimpse into residential construction practices. This data will serve as a benchmark from which future annual data can be measured against to identify trends.

Homebuilders are exposed to many risks in their profession. These risks include market risk, business risk, default risk and personal injury risk to mention a few. Unfortunately, many builders may be overlooking the risk of unlimited liability through the legal structuring of their companies. By simply creating a separate legal entity for a company, builders are able to limit their liability risk. Common business entities that provide the shelter of limited liability are corporations, limited liability companies, limited liability partnerships, limited partnerships, trusts, and estates.

This paper will provide an overview of the Texas residential construction industry and common legal entities used by builders. The research problem, literature review, data source, data collection, methodology, research findings, and conclusion will also be explained in the following sections.

Overview of the Texas Residential Construction Industry

Residential construction in Texas is somewhat unique when compared to U.S. trends and is dominated by two of its largest Metropolitan Statistical Areas (MSAs). To describe the residential construction industry in Texas, findings from the initial TRCC builder and home registrations, in 2004 and 2005, will be discussed. U.S. and Texas trends in new building permits issued will also be compared.

Figure 1, illustrates the number of building permits issued in the U.S. and Texas from 1980 through 2007 (NAHB, 2008 and Texas Real Estate Center, 2008). Trends in the number of permits issued appear to be somewhat similar, but have subtle differences across the same time horizon. In the 1980's, Texas experienced a decline in new starts while the U.S. was increasing. The U.S. lagged behind Texas trends from 1980 through 1991. Texas and U.S. trends in building permits were similar through 2004, and then Texas began to lag behind U.S. trends after 2005. Texas, beginning in 2006 and continuing through 2007, experienced a relatively large decline in new permits issued, falling back to levels last experienced in 2001. At the same time, the U.S., beginning in 2005 and continuing through 2007, experienced a level of new starts last seen in 1992.

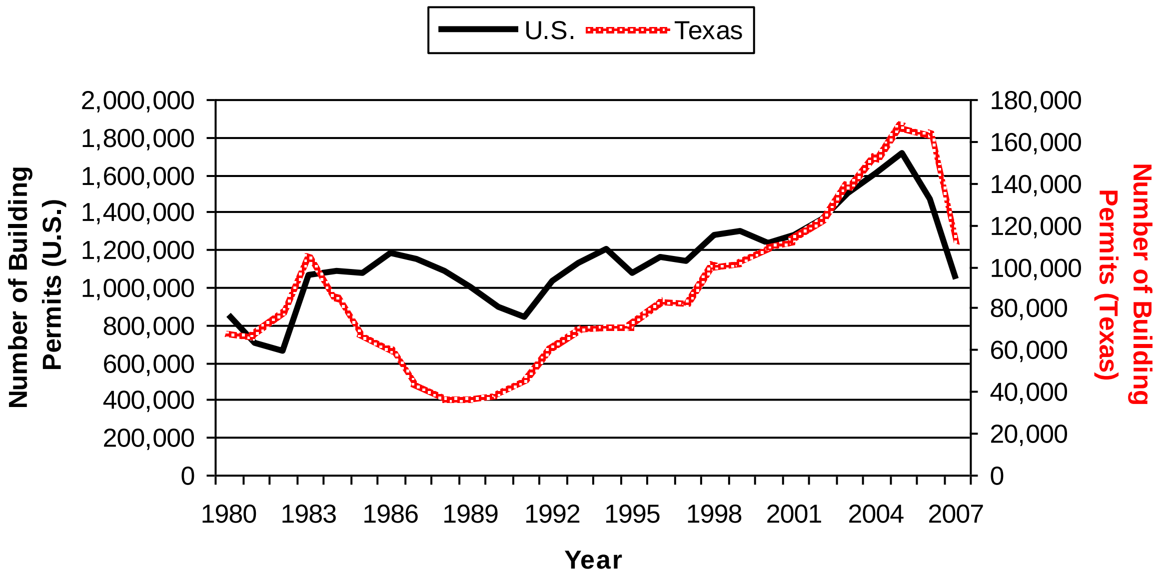

Figure 1: Building Permits Issued in the U.S. and Texas (1980-2007)

From January 2004 through December 2005, 26,663 homebuilders and 264,470 residential construction projects were registered with the TRCC. Figure 2 illustrates the number of active homebuilders in the top five MSAs of Texas. 89% of all registered builders were active in construction. Of that 89%, 23,788 builders, or 82%, were located in a MSA. Of the active builders, 63% were located or working in the top five MSAs. There were 18% more active builders in the Dallas Metroplex than in the remaining 20 MSAs combined.

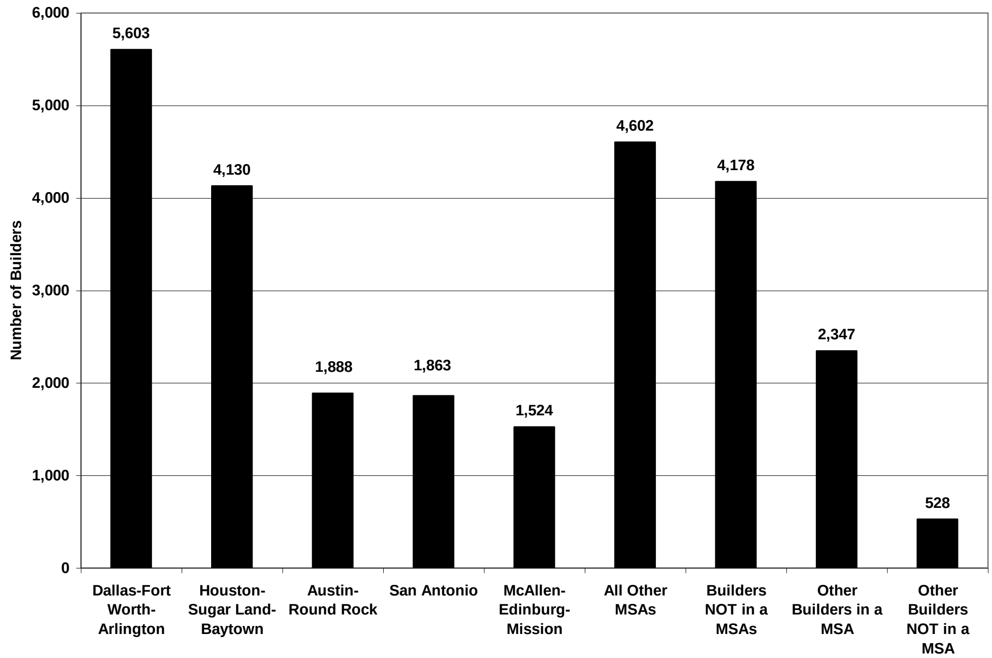

Figure 2: Number of Active Builders in the Top 5 MSA's of Texas (2004-2005)

Figure 3 shows where registered homes were being built or remodeled, by MSA, in Texas from 2004 through 2005. 96%, or 253,545, of the homes that were built or remodeled were located within Texas MSAs. The four MSAs with the largest amount of construction performed during this time period accounted for 82.31% of all residential construction work. The top two MSAs accounted for 61.84% of the residential construction projects in Texas.

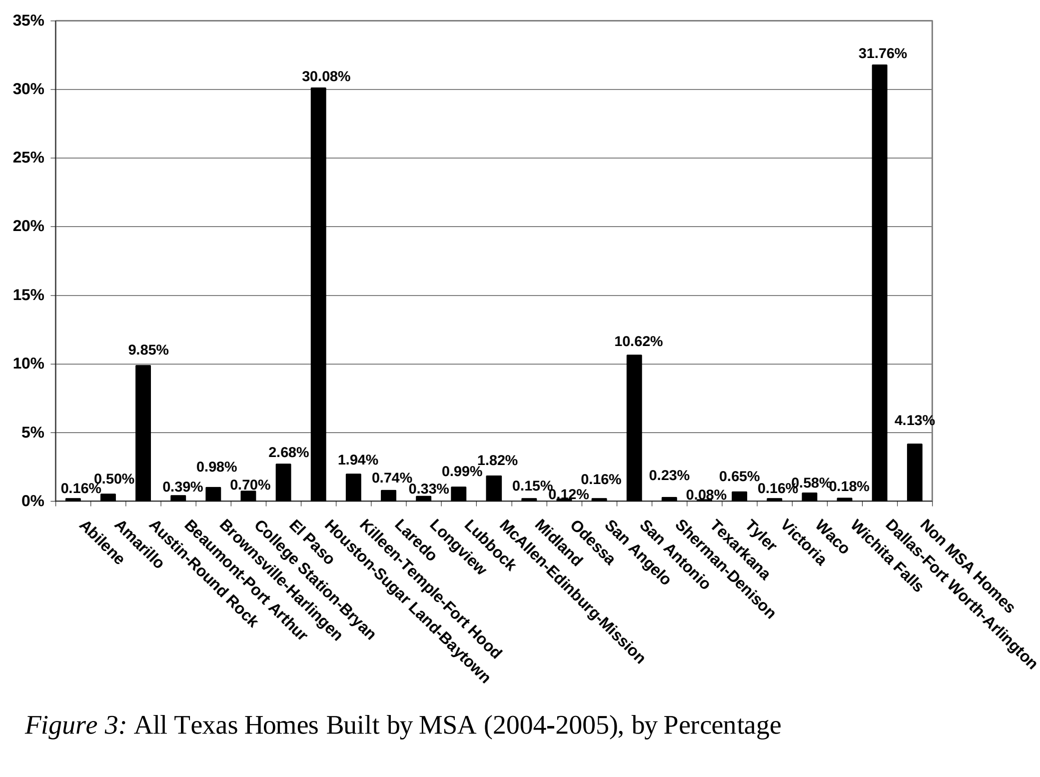

Figure 3: All Texas Homes Built by MSA (2004-2005), by Percentage

Overview of Legal Entities Used by Texas Homebuilders

A legal entity is an individual or organization which is legally permitted to enter into a contract, and can be sued if it fails to meet its contractual obligations. Selecting the type of legal entity under which the company will operate is one of the first and most important decisions of each new homebuilder. The legal entities typically used by Texas homebuilders include sole proprietorships, general partnerships, limited partnerships, corporations, and limited liability companies (LLCs). The following are brief overviews of these legal structures provided through the Office of the Governor of the State of Texas (TexasOnline, 2008):

Sole Proprietorship: "A sole proprietorship exists when a single individual operates a business and owns all assets. A sole proprietor is personally liable for all debts, and business ownership is nontransferable. Under a sole proprietorship, the life of the business is limited to the life of the individual proprietor. The sole proprietorship makes no legal distinction between personal and business debts, and it does not require a separate income tax return."

General Partnership: "A general partnership exists when two or more individuals or businesses join to operate a business. Under a general partnership, a separate business entity exists, but creditors can still look to the partners' personal assets for satisfaction of debts. General partners share equally in assets and liabilities. A general partnership requires an annual partnership income tax return (separate from the partners' personal returns)."

Limited Partnership: "A limited partnership is a partnership formed by two or more persons or entities, under the laws of Texas, and having one or more general partners and one or more limited partners. General partners share equally in debts and assets, while limited partners have limited debt obligations. A limited partnership must be registered with the Secretary of State."

Corporation: "A corporation (Subchapter C or S) is created when two or more individuals, partnerships, or other entities join together to form a separate entity for the purpose of operating a business in the state. A corporation has its own legal identity, separate from its owners. The corporation offers protection to the business owners' personal assets from debts and liabilities relating to the operation of the corporation. Taxation of the corporation varies depending on the type of corporation formed. A corporation must be registered with the Secretary of State."

"A Subchapter C Corporation is taxed at a higher rate than an individual. The owners are not taxed personally for profits; however, the owners do pay personal taxes on any salaries and/or dividends, and the corporation is also taxed on the profits."

"Owners of Subchapter S Corporations may deduct business losses on personal income tax returns, similar to a partnership. The Subchapter S Corporation also offers alternative methods for distributing the business income to the owners."

Limited Liability Company (LLC): "A limited liability company is an unincorporated business entity which shares some of the aspects of Subchapter S Corporations and limited partnerships, and yet has more flexibility than more traditional business entities. The limited liability company is designed to provide its owners with limited liability and pass-through tax advantages without the restrictions imposed on Subchapter S Corporations and limited partnerships. A limited liability company must be registered with the Secretary of State."

Most Texas homebuilders are designated as sole proprietorships, general partnerships, limited partnerships, corporations, or limited liability companies. The sole proprietorship and the general partnership, assuming the general partners are individuals and not firms, differentiate themselves in terms of exposure to unlimited liability. The descriptions of the aforementioned business entities can be explained in much more detail, but for the sake of this paper, are described in general terms.

Research Problem

Risks are inherent within the construction industry; however, many residential contractors may be exposing themselves to unnecessary risk through the legal structuring of their companies. Data gathered through the TRCC provides information concerning the inner workings of homebuilders in Texas. Prior to this study, little research had been conducted in this area of interest. By examining data collected by the TRCC, conclusions can be drawn about the common types of legal entities utilized by homebuilders in the State of Texas and the risks associated with those entities. This data will aid in the creation of a benchmark for future data to be measured against.

Peer Reviewed Literature Related to Homebuilding and Associated Risks

A number of peer reviewed articles have been published addressing the issue of risks associated with construction. These articles typically analyze risks that occur during preconstruction, construction, and post construction phases rather than the formation of legal entities. Abdou (1996) explained three types of risks surfacing in two different phases of the construction process. The first risk addressed was financial risk. The article emphasized that construction companies need to be careful in avoiding budget overruns which ultimately endanger the financial health of a company. These overruns can result from bad planning, wishful pricing, or poor coordination between design professionals and construction tradesman. The second risk proposed was related to time. Abdou warned that projects finishing behind schedule can have devastating financial consequences for construction companies. The final risk he explained related to the design of the building. There is a risk that the completed building will not meet the owner's needs. This problem can result from a designer influencing the owner towards a smaller building with a better quality finish rather than adequate space with an acceptable finish. Abdou stated that these risks apply to two different phases, the preconstruction phase and the construction and settlement phase. This study provides a good overview of preconstruction and construction risks but does not explore risk mitigation strategies addressed through the legal structuring of companies.

Kale and Arditi (1998) examined the effects of construction company newness, adolescence, and smallness on business failure. Data was obtained from Dun and Bradstreet's Annual Business Failure Records (1985-1994) related to companies classified under the Standard Industry Classification Code (SIC) including building construction general contractors (SIC 15), heavy construction general contractors (SIC 16), and special trade contractors (SIC 17). Dun and Bradstreet defined "business failure" as "a business that ceases operations following assignment or bankruptcy; ceases operations with losses to the creditors after such actions as foreclosure or attachment; voluntarily withdraws leaving unpaid debts; is involved in court actions such as receivership, reorganization or rearrangement; or has voluntarily compromised creditors." Kale and Arditi found an age-dependent pattern of failure with U.S. construction companies in which the risk of business failure increases in the first few years of a company's life, reaches a peak point, and decreases there-after as the company ages. They discovered an increasing risk of failure in the early life of construction companies can result from an initial assessment period, also known as the adolescence period. During this period a company's performance is assessed and a decision is made to continue or discontinue operations. They also learned that newness of a company, coupled with smallness, appeared to be the primary factors underlying the high probability of failure of construction companies. This study provides a thorough description of organizational theories related to construction company newness, adolescence, and smallness and offers insights related to trends of business failures. This study does not differentiate business failures based on organizational forms.

Sumutka (1997) explained the selection process of legal entities for small, closely held businesses. He explained that small companies desire to control their businesses with minimum interference from outsiders, to limit liability, to obtain tax free company paid fringe benefits, to minimize professional fees, and to minimize tax liability. This article compares and contrasts the C Corporation, the S Corporation, and the Limited Liability Company business forms. Sumutka does not conclude that one entity is best for small business owners. He provides a good explanation of the differences between these legal entities, but does provide an in depth comparison with sole proprietorships.

Methodology

The research question asks if Texas homebuilders are exposed to unnecessary risks through the legal structuring of their companies. To answer this question, quantitative data was collected from Texas homebuilders identifying how their companies were legally structured. For the purposes of this initial study, legal entity data was gathered and examined to create a benchmark from which a longitudinal study can be conducted. This paper is concerned with descriptive data; however, future studies will incorporate more data variables including company age, size, location, scope, and related variables so a regression model can be run to further examine relationships associated with business forms.

Data Source

The Texas Residential Construction Commission Act, which was passed through House Bill 730 during the 78th regular session of the Texas Legislature, called for the creation of the Texas Residential Construction Commission (TRCC, 2008). This Act requires residential construction projects, home builders, and remodelers to register with the State of Texas. The TRCC was given the responsibility for administering the registration process, overseeing the state-sponsored inspection and dispute resolution process, preparing and adopting limited warranties and building and performance standards, certifying third-party inspectors, overseeing task forces, providing a voluntary certification of arbitrators, and filing arbitration awards relating to residential construction (TRCC, 2008). As of 2004, only two other states, Arizona and Oregon, had a similar state-sponsored dispute resolution process, while five states, California, Florida, Michigan, New Jersey and Hawaii, had some level of state-sponsored review of construction-related issues.

Effective January 1, 2004, all home builders and remodelers in the State of Texas are required to register their company and each home construction project with the commission. Builders and remodelers must submit a “Builder/Remodeler Registration Form” and a “Home Registration Form” for new homes; including all single family homes, duplexes and certain townhomes; remodeling projects involving interior renovations exceeding $10,000; and, material improvements, defined as a modification to the home that either increases or decreases the home's total square footage of living space.

Data Collection

Data for this study was collected from registration forms submitted to the TRCC. According to the TRCC (2008), a builder or remodeler may not construct new homes or engage in remodeling projects that change the living area of the home or that cost more than $10,000 for interior renovations in Texas without first registering with the commission. Builders must fill out a TRCC promulgated “Builder/Remodeler Registration Form” (TRCC, 2008). This form requires builders to provide company information including legal name, address, phone number, fax number, email address, business type, primary business activity of company, assumed names used in residential construction, names of all builder partners and their percentage ownership, other company affiliations of the applicant, and designated agent criminal and financial history information.

The TRCC also requires a “Home Registration Form” to be submitted for every residential construction project under their scope (TRCC, 2008). Builders and remodelers must provide registrant information, the residential construction type, the filing date, the construction project address, and the homeowner’s mailing address.

Data obtained from registration forms were inputted into a database in order to be analyzed. This paper is concerned with data related to business types listed by contractors. Contractors must indicate whether their company is structured as a Limited Liability Company, Limited Liability Partnership, Limited Partnership, Corporation, Sole Proprietorship, General Partnership, Joint Venture, Estate, or Trust.

Research Findings

26,663 registered homebuilders and remodelers, from 2004 through 2005, provided the TRCC with information about their legal business structuring. Data was also collected from 264,470 construction projects performed by these builders. This section explains the related findings in detail. Since registering with the TRCC is a new requirement for homebuilders, this data does not include all Texas homebuilders due to a lag in the time for compliance.

The most common business entities used by registered homebuilders in Texas are shown in Figure 4. 49.54% of registered homebuilders are exposed to unlimited liability risk by being recognized as sole proprietorships. If the assumption is made that general partnerships consist of individuals rather than firms, then 51.41% of registered contractors do not have limited liability protection. Approximately 50% of all registered homebuilders have structured their companies to avoid unlimited liability.

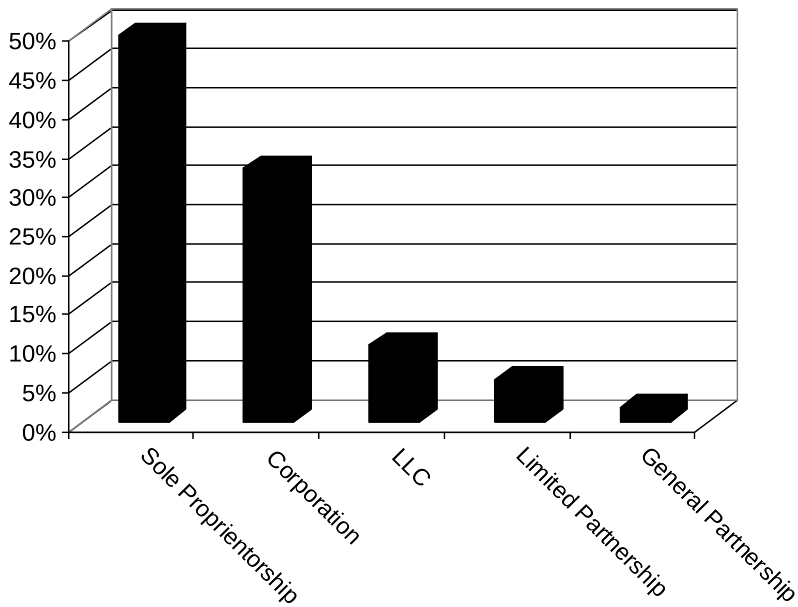

Figure 4: Common Legal Entities Used by Texas Homebuilders (2004-2005), by Percentage

Conclusion

This paper provides a unique glimpse into common business structures used by Texas homebuilders. Information detailing the legal entities used by 26,663 registered homebuilders in Texas, from 2004 through 2005, was obtained through the newly formed TRCC. Examination of initial data retrieved revealed that 49.54% of registered homebuilders are structured as sole proprietorships. This is a troubling trend for Texas homebuilders because there is an unnecessary exposure to liability risk. This information is especially alarming if Texas trends in homebuilder business structuring reflect those of other U.S. states.

Why would residential contractors not structure their companies to limit liability? This question would merit a future study, but there are potential reasons why. Many homebuilders are small in size and may not want to spend the time or the money it would take to create a separate business entity. Once a separate legal entity is created, the increased paperwork and costs for bookkeeping may be too burdensome. Some contractors may not be educated in the principles of business forms. Many are tradesman who started with small remodeling jobs and have grown their companies without feeling the need to convert to another organizational form. Sole proprietorships have the benefits of being easy to form and operate.

The negative aspects of sole proprietorships are that owners are personally liable for all debts and business ownership is nontransferable. The business life of the company is based on the life of the proprietor. This can make it difficult to obtain equity and debt funding for construction projects and company expansion. Sole proprietorships may thrive during expansion phases of market cycles; however, they can prove detrimental to owners during contraction phases.

Since the TRCC data is processed annually, initial findings from this study can serve as a benchmark from which a longitudinal study can be performed. Future studies can be conducted to further examine the size, scope, age, managerial backgrounds, and related variables of companies who are structured as sole proprietorships.

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