News | CONSTRUCTION

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Don't Miss Out: 2012 Offers Contractors Unique Estate Planning Advantages

Legislation passed in December 2010 created a window of opportunity for contractors to take advantage of estate and gift tax exclusions that will likely be legislated away by this year's-end. With valuations down as a result of the struggling economy and diminished construction spending, contractors may have the best opportunity in decades to maximize their opportunity for wealth transfer.

Understanding the Opportunity

On December 17, 2010, President Obama signed legislation, following Congressional approval, of a tax bill that extends the Bush-era tax cuts through 2012. Not only did the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("the Act") eliminate much of the uncertainty that was being faced regarding what the tax rates and rules would be for 2011, but it also included extensions of many expired provisions along with planning opportunities for income, estate, and gift taxes.

Though doubts still exist regarding what will happen after December 31, 2012, the estate tax exclusion amount has for now increased to $5,120,000 per individual and $10,240,000 per married couple for 2012. The top tax rate for estates in excess of the exclusion amount is currently 35 percent.

Also for 2012 (everything may change as of January 1, 2013), the gift tax continues to be reunified with the estate tax, meaning that an individual's exclusion may be used for gifts during life or for assets passing upon death. By example, an individual who has used their $1 million lifetime gift tax exclusion now has an additional $4,120,000 of available exclusion. Lifetime gifts over $5,120,000 are taxed at 35 percent. Further, there is a $5,120,000 generation-skipping tax ("GST") exclusion for 2012.

The technical concept of *portability* must also be considered. Portability endeavors to simplify the estate tax system by avoiding the need for families to undertake complex planning to maximize the use of both spouses' exclusions. It allows a surviving spouse's estate to use any unused Federal estate and gift tax exclusion based on the last deceased spouse. For example, if a husband dies survived by his wife and his estate only needed to use $3.5 million (plus indexing) of his exclusion, his wife can combine the unused portion of $1.5 million with her $5 million exclusion, thereby passing an additional $6.5 million estate tax free. The estate will be required to file a return and make an election by the first decedent's executor to transfer the unused portion to the surviving spouse. The portability provision does not, however, apply to the GST, nor does it assure the intended result. It is only the unused exclusion of the last deceased spouse that governs.

Absent action by Washington, the above rules sunset back to a $1 million estate/gift tax exclusion and a 55 percent tax rate. Also, the GST exclusion returns to $1 million (indexed for inflation from 1997).

Impact of the Construction Economy on Wealth Transfer

Since 2009 the construction industry has struggled with diminished construction spending, little private sector work, and increased competition for public sector jobs. Further, the real estate market has softened considerably. As a result, contractors face a lack of backlog, low real estate values, and a depressed equipment market. While these factors create challenges to operating a profitable business, they also contribute to lower business valuations. So, not only does this year provide opportunities for favorable tax treatment of transferred wealth, but also advantages in determining the value of the wealth to be transferred.

Of course, not every contractor that might consider taking advantage of the favorable conditions for wealth transfer is ready to do so. As many contractors struggled through the downturn, succession planning may have taken a back seat to survival. In fact, according to a study conducted by Heidrick & Struggles and Stanford University's Rock Center for Corporate Governance in 2010, only 50 percent of CEOs had a written document detailing the skills needed for the business's successor.

Further, consider the following statistics from the Association of General Contractors of America:

- 70 percent of closely held businesses do not make it to the second generation of owners, and
- 30 percent of those that do make it to second generation, don't make it to the third.

Historically, contracting has been a family business passed on from generation to generation, so the importance of properly planning for business transition cannot be overstated.

The first impulse for founders is to assume that the next generation is the natural choice for succession, but that's not always the case. It takes a certain personality to found and lead a successful construction company, and such personality traits are not automatically inherited. This makes it easier to understand why the majority of companies do not survive the cross-generation transition. If your goal is simply to keep the business in the family, you need to identify the best candidates for leadership and train them appropriately. Take action to surround the leadership candidate with a core team of experienced management advisors. Consider forming a board of directors that includes external advisors that can provide experience and direction and offers a sounding board for leadership issues.

However, if your goal is to maximize the value of the business to the family, when there is no clear future leader within the owner's bloodline, the best course of action may be to pursue alternative plans. Your team of trusted advisors can help in evaluating whether there are key members of management capable of leading the organization, offer insight into the potential of bringing in outside talent, and assist in evaluating whether pursuing private equity or a strategic buyer offers the best means of achieving your objectives.

Take the First Step

Discuss your plans with your accountants and attorneys so they can assist you in evaluating your options. It is recommended that, as part of any business transfer or estate planning endeavor, every will and revocable trust be reviewed for conflicting provisions with current intent and the interaction with the new law. State transfer taxes must be carefully considered as they have significant impact on costs and payments. A tax and estate planning advisor should review transfers to grantor trusts and note sales. It is critical to question the continued use of GRAT vs. outright gifts, and the elimination or lessening of guarantees on trust obligations by added additional gifts to the trust using the $5,120,000 exclusion. You'll need sound counsel to make optimal decisions.

Wealth Transfer Considerations

When preparing to transition leadership in a family or closely held business, there are numerous tax, wealth transfer, and operational considerations to undertake, including:

- The role of comprehensive financial planning to create increased business value
- Degree of financial interdependence (family/business overlap)
- Potential schisms between active and inactive family members
- Methods of ownership transfer—gifting, equity compensation, or selling the owner's interest?
- Timing—Will the transfer take place before the owner's death (which speaks to the owner's confidence in the new leadership) or after?
- Funding the transfer—Split-dollar insurance, owner financing, or deferred compensation model?
- Estate planning for the owner—Determining the role of life insurance trusts, family limited partnerships, Grantor Retained Annuity Trusts (GRATs), and Self-cancelling Installment Notes (SCINs)
- Contingency planning—What happens if the new leadership fails to meet expectations?

But Take Action Now

Every contractor's situation is unique, but given the state of the construction economy and the current tax environment, most owners owe it to themselves and their family to consider the current state of their succession and estate plans and evaluate what actions, if any, they should take this year to help them achieve their objectives. Under the sunset provisions, delaying action could cost a contractor's estate millions. ■

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Summary of Estate and Gift Tax Changes

	2009	2010	2011	2012*
Estate tax exclusion	$3.5 million	May elect $5 million or no Federal estate tax	$5 million	$5,120,000
Lifetime gift tax exclusion	$1 million	$1 million	$5 million	$5,120,000
GST tax exclusion	$3.5 million	$5 million	$5 million	$5,120,000
Maximum estate, gift, and GST tax rates	45 percent	35 percent (but 0 percent GST tax in 2010)	35 percent	55 percent
Basis adjustment upon upon death	For all of the decedent's assets	May elect for (i) all assets or (ii) allocate $3 million increase to spouse and $1.3 million increase to others	For all of the decedent's assets	For all of the decedent's assets

**Note that the provisions are scheduled to sunset December 31, 2012*

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