One of your friendly competitors mentions that he received two times revenues when he recently sold his agency. But did he really? While many people want to know what an agency is worth as a multiple of revenues, a revenue multiple is not the relevant factor.

Assume an agency has $1 million in revenues and a revenue multiplier of 1.5. Would you be willing to pay $1.5 million for a $1 million revenue agency whose fixed expenses are $1.1 million a year? Of course not. Why would you pay anything to lose $100,000 per year?

What is relevant is the net cash flow of the agency. Whether you value an agency as a multiple of EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization), use a Return on Investment Calculation, or calculate the Net Present Value of Future Cash Flow, many agency

Tax Implications of Buying and Selling Agencies

Planning Ahead is a MUST!

BY JON PERSKY, CIC, CPA, PHR

owners are beginning to realize that the valuation of an agency is more complicated than a simple multiple of revenues.

But there are more factors to consider than just price. What are the terms of payment? Are you getting 100% cash up front, or are you taking payments over time? Is the deal with or without a retention factor? How is the purchase price being allocated? And most importantly, what is the structure of the deal?

What Are You Selling?

There are two ways to sell an agency: either as a stock purchase or an asset purchase. Based on a study done by The National Alliance Research Academy for the book *Maximizing Agency Value II: A Guide for Buying, Selling, and Perpetuating Insurance Agencies,* four out of five agency sales are done as asset purchases. Depending on the deal structure and the buyer and seller's types of entities, significant tax implications can arise.

Of critical importance is how much money the seller will be left with after paying Uncle Sam. Structure the deal the wrong way and your least favorite uncle could end up with more of the proceeds than you do.

Asset Sale

Let's assume Joe Jones is a 100% shareholder of Jones Insurance Agency, Inc. (JIA), a C Corporation, and Bob Brown is 100% shareholder of Brown Insurance, Inc. (BII), an S Corporation. Joe agrees to sell the assets of JIA to BII for $1 million cash up front. Bob writes out a BII check for $1 million payable to JIA. At this point, Joe is pretty happy and is dreaming about what to do with his money. Unfortunately, Joe wanted to save money and didn't bother to consult with his CPA, attorney, or business consultant.

April 15th rolls around, and Joe's CPA tells him that JIA owes the State Department of Revenue 5% ($50,000). JIA also owes the IRS $323,000 ([$1 million – $50,000] x 34%). At this point, JIA is left with $627,000 and Joe writes out a check from the agency made payable to himself for the $627,000.

$1,000,000	Income
–50,000	5% State Dept. of Revenue
–323,000	(1,000,000 – 50,000) x .34 to IRS
627,000	
–25,080	4% State Tax
601,9200	
–90,288	601,920 x .15 Capital Gains Tax
$511,632	

Assuming an individual state tax rate of 4%, Joe now owes an additional $25,080 to the state and, of course, the IRS wants capital gains tax (currently 15%) on the $601,920 ($627,000 – $25,080). After paying Uncle Sam $90,288, Joe is left with $511,632, a far cry from the $1 million sale price of the agency.

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Tax Implications

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Now let's assume that instead of being a C Corporation, Jones Insurance Agency is an S Corporation. Since S Corporations generally don't pay taxes, the $1 million of sales price will flow onto Joe's K-1 from the corporation as income. (While this is normally a split of ordinary income and capital gains, let's assume the entire amount is ordinary income for ease of example.) Joe will pay the state its 4% ($40,000) and Uncle Sam its $326,400. Joe is left with $633,600. Better, but not great.

$1,000,000	Income
–40,000	4% State Tax
–326,400	(1,000,000 – 40,000) x .34 to IRS
633,600	

If Joe files a plan for dissolution for JIA with the IRS, the $1 million becomes capital gains. Joe pays $40,000 to the state and $144,000 (($1million - $40,000) x 15%) to the IRS, leaving him with $816,000. If JIA is a sole proprietorship, Joe would also be left with $816,000.

$1,000,000	Capital Gains
–40,000	4% State Tax
–144,000	(1,000,000 – 40,000) x .15 to IRS
$816,000	

In all of the above cases, the tax implication to the buyer, Brown Insurance, Inc. is the same. Brown gets to amortize the $1,000,000 purchase price straight-line, over 15 years, resulting in a tax deduction of $66,667 per year for 15 years.

Converting From C to S Status

Sellers sometimes think that they can quickly convert from a C Corporation to S Corporation status to avoid the double taxation implications of a sale. This is where the 10-year rule comes into play.

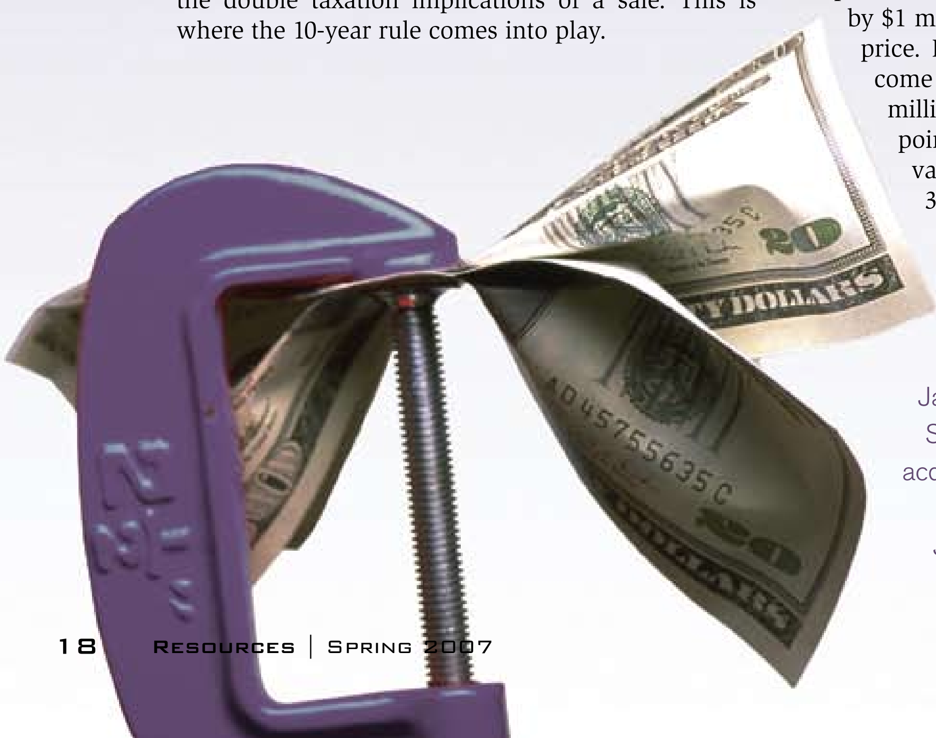
Let's assume JIA converts from C to S status on December 31, 2006, and his basis in the agency is zero (he started the agency from scratch). If Joe sells JIA's assets on or after January 1, 2017, the entire sales price is treated as an S-status Corporation. But if Joe wants to sell JIA's assets prior to January 1, 2017, he has a problem. It will be treated as a C Corporation unless Joe has his agency valued as of December 31, 2006, for a conversion as of January 1, 2007 by an independent third-party consultant. Let's assume the consultant values the agency at $800,000. If Joe sells the agency's assets any time prior to January 1, 2017, the first $800,000 will be treated as C Corp, and any remaining balance of the purchase price will be treated as an S Corp.

The valuation should be done by a qualified third party to significantly reduce the potential of the IRS questioning the assigned value. Further, Form 1120S, page 2, should be filed with the IRS with the December 31, 2007 tax return, indicating the amount of unrealized built-in gains at the date of conversion. This amount is put on page 2, so that the IRS can track the gain if a sale happens within the 10-year period. This amount is based on the valuation as of the date of conversion (January 1, 2007 in this example).

Stock Purchase

In a stock purchase, the buyer will be buying Joe's stock in JIA from Joe personally. The buyer writes out a check made payable to Joe for $1 million, and Joe will end up netting $816,000 after paying the 4% state tax and federal capital gains taxes.

While this may seem a simple solution to the double taxation problem of a C Corporation, most buyers are reluctant to enter into a stock purchase. With a stock purchase, the buyer increases his basis (in this example by $1 million) but never gets to amortize the purchase price. In essence, Bill trades a $66,667 ordinary income tax deduction for the next 15 years, for a $1 million capital gains tax deduction at some future point. Not only is there an impact due to the time value of money, but Bill is potentially trading 34% tax deductions for a 15% tax deduction.



Learn More, Earn More

You'll learn about agency taxation issues pertaining to mergers and acquisitions at James K. Ruble Agency Management Practices Seminars. Detailed information on mergers and acquisitions can be found in the book *Maximizing Agency Value II: Perpetuating, Buying, and Selling Insurance Agencies,* available from The National Alliance Research Academy.

Of even greater importance is the fact that if Bill buys Joe's stock, Bill is assuming all of the hidden or unknown liabilities of JIA. Although you can somewhat mitigate this by having Joe sign an indemnification agreement, Bill will still have to pay the liability and then seek repayment from Joe. Will Joe have the funds to repay Bill? Will Bill even be able to locate Joe?

These are the reasons that most stock purchases are between family members or between multiple shareholders of a corporation.

Trading Vested Books for Stock Ownership

Some agencies allow producers to vest in their personal books of business. At some point down the line, the owner of the agency wants to bring in the vested producer as a stockholder for agency perpetuation purposes. The agency owner suggests that the producer "swap" his vested interest in his book of business for a similar value of agency stock. Unfortunately, it's not as easy as it sounds and will have significant tax implications to the producer.

Before the producer even considers the swap, there are several issues that must be addressed:

1. How will the agency and/or the book of business be valued? This will impact the percentage of stock the producer will receive.
2. What is the tax impact to the producer?
3. Does the agency have an acceptable Shareholders Agreement that specifically addresses death, disability, retirement, divorce, voluntary and involuntary termination, both with and without cause?

Let's assume ABC Agency is worth $2.5 million, (including Pete's book of business) and Pete the producer has a book of business with ABC Agency worth $500,000. Pete is 50% vested in his book and the owner of ABC Agency approaches Pete about "swapping" his $250,000 ($500,000 x 50%) ownership in his book for 10% of the stock of the agency. Unfortunately for Pete, this is not a "like kind exchange," nor can it be considered a corporate reorganization. When he receives 10% of the stock of ABC Agency, he should also receive another piece of paper, a W-2 for $250,000 (10% of the $2.5 million) that he will have to pay taxes on. Assuming Pete resides in a state with an income tax rate of 4%, he will pay $10,000 to the state and $81,600 to the IRS (assuming a marginal tax rate of 34%). Does he have the money?

$250,000	10% of 2,500,000
–10,000	4% State Tax
–81,000	(250,000 – 10,000) x .34 to IRS

Advanced planning, sometimes *years* in advance, is crucial...

It should be noted that if an agency is considering hiring a seasoned producer who is coming with a book of business, it may be possible for the producer to be treated as an independent contractor with his own corporation, and later consider doing a stock swap to mitigate the tax impact to the producer.

Summary

Buying, selling, and perpetuating insurance agencies can be complicated transactions that have significant impact on both the buyer and seller if not structured properly.

Advanced planning, sometimes years in advance, is crucial for agency owners to maximize the after-tax money they receive for their agencies. Agency owners are wise to hire qualified consultants who can assist them with agency valuation, corporate structure, perpetuation planning, shareholders agreements, and the related tax implications. ■

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