

A decorative graphic at the top of the page shows a series of spheres on a ramp. One sphere is red, while the others are grey. The ramp is a grey, curved surface that slopes downwards from left to right. The spheres are arranged in a line along the top edge of the ramp, with some appearing to be rolling down. The background is white.

Tax Implications *buying and selling* AGENCIES

By Jon Persky, CPA, CIC, PHR

One of your friendly competitors mentions he got twice revenue 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 1.5x. 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 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 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 percent cash up front or are you taking payments over time? 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 Academy of Producer Insurance Studies 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 type 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 percent shareholder of Jones Insurance Agency Inc., a C corporation, and Bob Brown is 100 percent shareholder of Brown Insurance Inc., a 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. Unfor-

tunately, Joe wanted to save money and didn't bother to consult with his certified public accountant, attorney or business consultant.

April 15 rolls around and Joe's CPA tells him that JIA owes the New York Department of Revenue \$75,000 (state corporate tax rate of 7.5 percent). JIA also owes the Internal Revenue Service \$314,500 $(\$1 \text{ million minus } \$75,000) \times 34 \text{ percent}$. At this point JIA is left with \$610,500 and Joe writes out a check from the agency made payable to himself for the \$610,500.

Assuming an individual tax rate of 6.85 percent, Joe now owes an additional \$41,819 to the state and, of course, the IRS wants capital gains tax (currently 15 percent) on the \$568,681 (\$610,500 minus \$41,819). After paying Uncle Sam \$85,302, Joe is left with \$483,379, a far cry from the \$1 million sale price of the agency.

Now let's assume that instead of being a C corporation, JIA is a 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 normally is 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 7.5 percent (\$75,000) and Uncle Sam its \$314,500. Joe is left with \$610,500. Better, but not great. If Joe files a plan for dissolution for JIA with the IRS, the \$1 million becomes capital gains. Joe pays \$75,000 to the state and \$138,750 ((\$1 million minus \$75,000) x 15 percent) to the IRS, leaving him with \$786,250.

If JIA is a sole proprietorship Joe also would be left with \$786,250.

In all of the above cases, the tax implication to the buyer, BII is the same. Brown gets to amortize the \$1 million 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 they can 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 Dec. 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 Jan. 1, 2017, the entire sales price is treated as a S status corporation. But, if Joe wants to sell JIA's assets prior to Jan. 1, 2017, he has a problem. It will be treated as a C corporation unless Joe has

his agency valued as of Dec. 31, 2006, for a conversion as of Jan. 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 anytime prior to Jan. 1, 2017, the first \$800,000 will be treated as a C corporation and the remaining balance of the purchase price will be treated as a S corporation.

The valuation should be done by a qualified third party to significantly reduce the potential of the IRS questioning the assigned value. On the first S corporation tax return (for the year ending Dec. 31, 2007, Form 1120S), the agency value (as of Dec. 31, 2006) should be put on page 2 so that the IRS can track the gain if a sale happens within the 10-year period.

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 \$786,250 after paying state 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 potentially is trading 34 percent tax deductions for a 15 percent tax deduction.

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 still will 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 issues that must be addressed:

- How will the agency and/or the book of business to be valued? This will impact the percentage of stock the producer will receive.
- What is the tax impact to the producer?
- Does the agency have an acceptable shareholders agreement that specifically addresses death, disability, retirement, divorce, voluntary and involuntary terminate 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 percent vested in his book and the owner of ABC Agency approaches Pete about "swapping" his \$250,000 (\$500,000 times 50 percent) ownership in his book for 10 percent of the stock of the agency. Unfortunately for Pete, this is not a "like kind exchange" and when he receives 10 percent of the

[continued on page 35]

Tax Implications

[continued from page 33]

stock of ABC Agency he also will receive another piece of paper, a W-2 for \$250,000 (10 percent of the \$2.5 million) that he will have to pay taxes on. If Pete resides in New York state with a state income tax rate of 6.85 percent, he will pay \$17,125 to the state and \$79,178 to the IRS (assuming a marginal tax rate of 34 percent). Does he have the money?

It should be noted that if an agency is considering hiring a seasoned producer that 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 can 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 agency. Agency owners are wise to hire qualified consultants that can assist them with agency valuation, corporate structure, perpetuation planning, shareholders agreements, and the related tax implications.

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