

Timing is essential in selling your agency



Timing can be one of the most important things you need to consider when you're thinking about selling an agency. Why? Because the current capital gains tax rate (through the end of 2010) is at a historical low rate of 15 percent for the higher marginal income tax rates. While it's unclear whether the capital gains tax rate will rise over the next two to three years, it's a safe bet that it will not go down.

Assuming Congress takes no action in 2010, under the existing laws, the capital gains tax rate will automatically increase to 20 percent on January 1, 2011 for a whopping 33 percent increase.



So how does this affect owners of retail insurance agencies, MGAs, and MGUs who are contemplating a potential sale or creating a perpetuation plan? Capital gains taxes can dramatically impact on what you "take to the bank."

For example, if you assume risk in the transaction's ultimate valuation by taking some form of contingent payments, you're subjected to numerous factors beyond your control. These can include changes in local and national economic conditions, carrier underwriting and investment results, insured losses that impact contingencies or profit sharing, soft market pricing, required technology upgrades, and the prevailing capital gains tax rates.

Out of this list, capital gains are the one problem you have some control over. A capital gain is the profit realized from the sale of a capital asset. Capital gains occur any time you sell an asset that has appreciated in value. A capital gain is measured by the difference between the net sale price of the asset and your cost basis in that asset. The cost basis is typically defined as the amount you initially paid for the asset, adjusted for depreciation, the cost of improvements, and various other considerations. In many cases, the cost basis for an agency is very low resulting in most of the net proceeds of a sale being taxed at the existing capital gains rate.

Furthermore, the capital gain upon which the tax is calculated is not adjusted for inflation. Thus, a gain that is entirely due to inflation is not a real gain at all. It's an illusory gain which is taxed at the prevailing rates.

The good news is that the seller decides when to pay the capital gains tax. As a seller, you can defer this tax indefinitely if you take no action or defer your payout. The impact of this "lock-in effect" is easy to measure from one year to the next, but becomes increasingly harder to calculate over longer periods of time. Below is an example as to how the capital gains tax can impact net sales proceeds. It illustrates the required operating improvements a seller must achieve in order for the sale of your agency to be tax neutral when compared to the current 15 percent capital gains tax rate.

Assumptions:

Pro forma Revenue		\$715,000	
Pro forma EBITDA		\$143,000	
Gross Sales Price @ 7x Pro forma EBITDA		\$1,000,000	
Adjusted Cost Basis		-0-	
Net Capital Gain			
100% Sales Price Paid @ Closing			

Capital Gains Tax Rate	<u>15%</u>	<u>20%</u>	<u>30%</u>
Net Proceeds to Seller	\$850,000	\$800,000	\$700,000

Required ↑ in EBITDA for the Seller to Net

the Same @ 5% the Capital Gains
Tax Rate

\$ Increase	\$8,786	\$30,469
% Increase	6.14%	21.31%

As the above example illustrates, the impact of rising capital gains tax rates has a significant impact on the net proceeds that are “bankable” to a seller.

With higher capital gains taxes lurking in the future, your agency must either grow its revenues and/or improve its profit margins just to net the same proceeds under the current tax rates. This is a difficult task especially when many agencies are reporting no real organic growth. The ever increasing demands for improved agency performance calls for a risk/reward analysis that every agency owner should undertake on a routine basis.

Before you take any action, it is highly recommended that you consult a professional M&A firm as well as your tax advisor as to transaction structure, timing, consideration used and numerous other factors which could influence your “money in the bank.”

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