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With Tax Cuts Set to Expire, Consider a Partial Sale of the Agency

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"Nothing is certain except death and taxes," said Benjamin Franklin. For independent insurance agency owners considering a sale of their business, they may find the certainty of income taxes to be elusive for 2026. The looming uncertainty relates to the reality that when agency owners sell their business, it's not what they get that is important, rather it is what they get to keep.

Although agency owners often focus on the multiple of an agency's revenues or cash flow that is used in calculating the sale price, the deal terms are equally significant. Most agency sales — but not all — involve the purchase of the agency's assets rather than a stock purchase to limit the liability exposure of the buyer.

The typical approach uses an installment payout and often involves an employment agreement with the agency owners that they will stay with the agency for a specified number of years (one, three or five years, for example) with an earnout provision relating to the final payment. The earnout provision is used to motivate the sellers to continue to increase the value of the agency during their employment.

Even if they own 100% of the business, agency owners have a silent partner in the sale: the taxman.

Although the tax implications of an agency sale are often contemplated in structuring the deal, what is not known is the status of the Tax Cut and Jobs Act (TCJA). Enacted in 2017, it lowered corporate tax rates to 21% and, for pass-through entities like S Corps, LLCs, LLPs and sole proprietors, it introduced a qualified business income (QBI) deduction of 20%.

Approximately two-thirds of all independent insurance agencies are pass-through entities.

Of great significance is that the TCJA lowered the capital gains rates in most cases. However, the TCJA is scheduled to sunset at the end of 2025, which means that tax rates will revert to pre-2017 levels, and the capital gains rate will be linked to the taxpayer's ordinary income tax bracket as it was before the TCJA was enacted.

Regardless of which party had won the November presidential election, in an era of massive federal deficits there are political uncertainties about the ability to renew the TCJA.

If not renewed, the after-tax earnings of agency owners will decrease, and the net sale proceeds will be lower on an after-tax basis.

Agency owners who are not yet ready for a total sale of the agency may be more motivated to sell a portion of their agency during 2024 and 2025.

A partial sale of the agency to a key staff member (or members) accomplishes two objectives:

- It helps perpetuate the agency by retaining key staff and establishing the future leadership regime. A stock purchase loan can be arranged to provide funding for the partial sale.
- It assists the agency owners in diversifying their personal balance sheet and provides for tax efficiency of their return on assets.

Consider a Stockholder Loan

Keith Mangini, VP commercial lending, for InsurBanc, cites an example.

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"We recently helped a second-generation agency owner address his need to retain a key producer by using the vested value of his book of business in conjunction with capital that we provided in the form of a stockholder loan, which served as the basis for purchasing a minority interest in the entire agency. This solved the needs of both the agency owner and key staffer," he explained.

"Further, it reassured other agency staff that there *is* a perpetuation plan in place, creating a certainty about the agency's future."

The psychological advantage of using a stockholder loan to facilitate a partial sale of the agency is that agency owners often procrastinate when it comes to perpetuating their agency.

Industry consultants recommend that planning for perpetuation should ideally start 10 years — but certainly no later than five years — before the planned agency sale or their exit from the agency.

Since the stockholder loan necessitates an agency valuation, it establishes a process for future agency transactions and helps overcome the tendency to procrastinate.

With a stockholder loan, customarily there is a buy-back feature that provides the agency with the first right of purchase of the minority ownership.

Regarding the potential reversion at the end of 2025 to higher tax rates, the agency owners can take advantage of current capital gains rates and diversify their personal balance sheet.

Or they can use the proceeds to invest in the agency's capabilities, acquire a smaller agency or recruit other insurance professionals with specific expertise to serve a target industry.

Now, while the tax environment is known, is an opportune time for agency owners to reassess their personal timeline. If your agency has been procrastinating on its perpetuation plan, keep in mind that as Caesar was warned that, "the Ides of March are approaching," so too is the potential sunset of the TCJA at the end of 2025. ■

Scott Freiday is senior vice president and division director of InsurBanc, a division of Connecticut Community Bank, N.A. He oversees the bank's commercial lending and cash management operations and has nearly a quarter century of experience in domestic and international banking and financial services. InsurBanc specializes in financial products and services nationally for the independent insurance distribution community. Started in 2001 as a vision of the Big "I," InsurBanc finances acquisitions and perpetuations and helps agencies become more efficient by providing cash-management solutions.

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