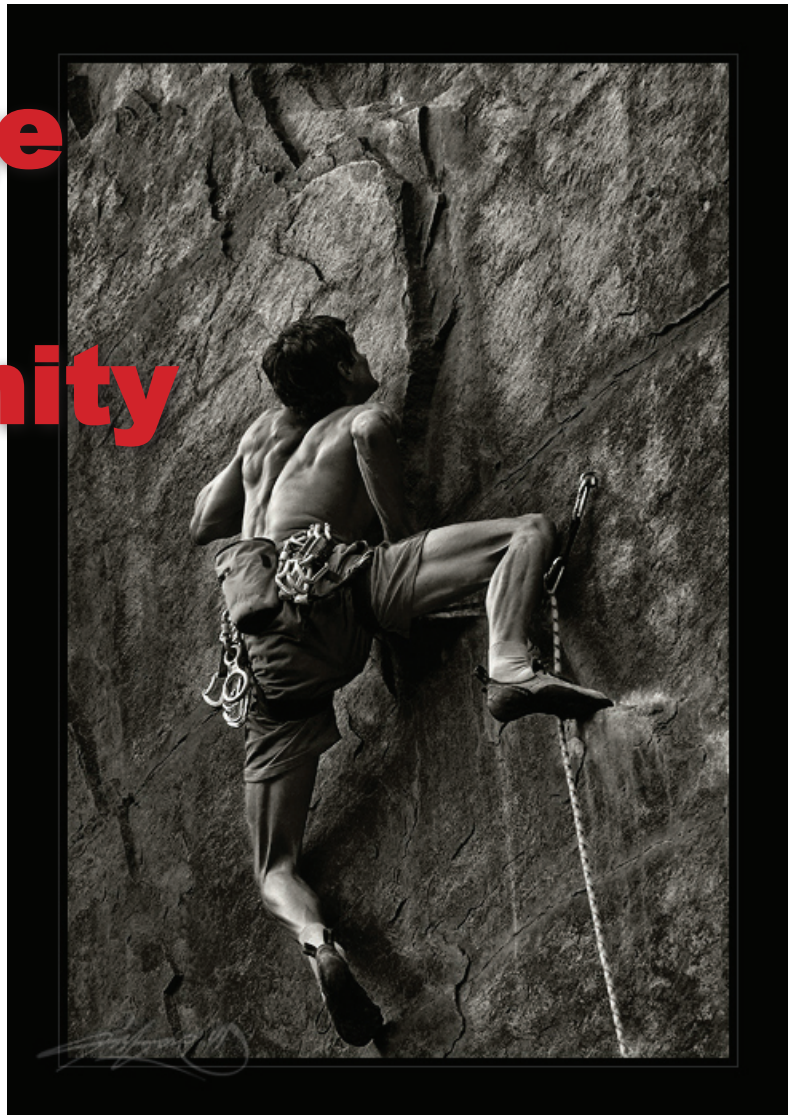


Challenge Based Opportunity

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For all, the current economy presents significant risk to health, wellness and financial stability. The landmines that lay on the horizon are immense and often seem insurmountable given a daily deluge of negative information. We all see challenges, but those with vision and courage recognize that peril often begets opportunity. It has often been said that.... More wealth was created from strategies executed because of the Great Depression than from any other single event in this country's history... Can the current environment present opportunity? It can for some. Especially those who have put some cash under the mattress during the past few years. With insurance agency valuation at the lowest point in decades, now may be the time for those with dry gunpowder to consider cautiously executing an acquisition strategy. For those that wanted to sell, but were stuck in molasses due to the 10 year built-in gains tax holding period, legislative changes now allow some to *grab* capital gains in an asset sale *versus* suffering *double taxation*. While valuations have declined, those select few that have been given a brief window of opportunity can offset the impact of lower valuation by securing the lowest long-term capital gains rate since the Great Depression. A rate that WILL increase.



At present, the proposal on the drawing board recommends an increase in the long-term capital gains rate to 20%, or an additional 5 percentage points above the current 15%. As the economic plans unfold, it is quite possible that the increase will be even greater. This presents a very brief retirement life preserver for some that have elected S-Corp status years ago, but did so too late. The change in the built-in gains tax period could turn out to be a life changing net valuation opportunity for some sellers if capital gains creep up to 39% as they did after the Great Depression. This article is dedicated to those that look at these times as an opportunity and to those willing to skip a few chapters of the current book and envision strategies that will turn challenges into opportunity.

On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Tax Act of 2009 (the "Act"). The Act contains approximately \$300 billion of net tax cuts for individuals and businesses. Tax incentives for businesses include:

- *Extension of 50% bonus depreciation on capital expenditures incurred in 2009; (2010 for property with a recovery period of more than 10 years).*
- *One year extension of the 2008 increased section 179 expense limits of \$250,000 maximum with an \$800,000 phase-out ceiling.*
- *Extension of Net Operating Loss carry-back period, from two years to five years, for small businesses with gross receipts of \$15 million or less.*
- *Delayed Recognition of Certain Cancellation of Debt Income – Certain cancellation of debt (COD) income that arises from a firm's reacquisition or restructuring of its business debt during 2009 or 2010 can be deferred until 2014, then included in income ratably over five years (2014 -2018).*
- *Increased capital gain exclusion for small business stock issued after February 17, 2009 and before January 1, 2011. The Act increases the portion of the gain excluded on the sale of qualified small business stock held for more than five years from 50% to 75%.*
- *Temporary reduction of S Corporation Built-In Gains Holding Period from 10 years to 7 years for sales occurring in 2009 and 2010 - In other words, corporations that became S firms before 2003 and are sold in 2009 or 2010 are not subject to double taxation (a corporate level tax on gains from assets owned prior to the switch and then capital gains tax on the proceeds distributed to the shareholders). These same rules will apply to corporations that became S firms in 2003 and are sold in 2010.*

While this list is not all inclusive, the majority of the Act's tax cuts are temporary, primarily affecting tax years 2009 and 2010.

In addition, on February 26, 2009, President Obama released his proposed 2010 fiscal budget outline to Congress. The budget, which is aimed to pull the nation out of the current financial crisis, projects that the government's deficit for this year will soar to \$1.75 trillion. While complete details are not due to be released until late April, it is clear that the budget extends the middle class tax cuts passed by the Bush administration in 2001 and 2003, but lets cuts for the wealthy expire to

help pay for his plan. Obama's budget proposal would effectively raise income taxes and curb tax deductions on couples making more than \$250,000 a year and individuals making more than \$200,000 a year, beginning in 2011. By not extending Bush's tax cuts for such wealthier filers, Obama would allow the marginal rate on household incomes above \$250,000 to rise from 35 percent to 39.6 percent. Likewise, the long term capital gains rate will increase from 15% to 20% for most individuals.

A combination of many factors, including the current state of the economy, the continuing soft market in the property and casualty insurance industry, declining agency values, the increase in individual and capital gains tax rates in 2011, along with the temporary reduction in the S Corporation Built-In Gains Holding Period leaves 2009 and 2010 as a short *window of opportunity* for both buyers and sellers of independent insurance agencies.

The current state of the economy, with banks struggling to survive and credit markets all but dried up, has reduced the number of viable buyers. Similarly, the threat of national health care, pending tax increases, aging owners and the continuing soft market has increased the supply of agencies wanting or needing to sell.

This combination of increased supply and decreased demand has had the expected effect of decreasing the valuation multiples now seen in today's merger and acquisition environment. This decrease in agency values now enables larger agencies that have weathered the economic storm to be able to compete on pricing. For a larger agency with a strong balance sheet, 2009 and 2010 could provide the ideal opportunity to purchase an agency or book of business.

In general, buyers prefer and pay more to purchase the assets of a corporation than to purchase the stock of the same corporation. By purchasing assets, a buyer not only is able to deduct the purchase price from taxes in the form of depreciation and amortization, it can also limit the liabilities assumed.

% Deals	
Total 2008 Deals	100%
C Corp	20%
S Corp	67%
LLC	13%
Asset	73%
C Corp	9%
S Corp	73%
LLC	18%
Stock	27%
C Corp	50%
S Corp	50%
S Corp Deals	100%
Asset	80%
Stock	20%

MarshBerry is intimately involved in dozens of independent insurance agency transactions each year (see back page). As such, we have developed a database capturing current in-depth information about insurance agency transactions. Based on our database, 73% of the transactions in 2008 were asset purchases. Of those, 91% of the sellers were either an S corporation or an LLC. Stock purchases represented 27% of the transactions and 50% of the stock purchases were S corporation sellers. In most cases, the S corporations selling stock were S corporations for less than 10 years and subject to built-in gains tax under an asset purchase scenario. The average EBITDA multiple paid in asset transactions averaged about 20% higher than the average paid in stock purchases.

For a seller, an asset transaction can create a double tax situation if it is a C corporation or if it is an S corporation still within the built-in gains recognition period (the 10 year period starting on the day of the S election). In both of these situations, the corporation is subject to corporate level tax on the gain realized from the sale of its assets (for an S corporation within the built-in gains recognition period, the value at the time of S corporation election is subject to the corporate level tax). Then, once the after-tax proceeds are distributed, they are subject to tax again at the shareholder level. This double taxation is completely avoided if an S corporation is beyond the built-in gains recognition period. In these situations, the corporation (via the value of the corporation at the time of S election) no longer is subject to tax on the gain recognized by the sale of its assets. The gain is simply passed through to the shareholders who are taxed once at the long-term capital gains rate.

Since the American Recovery and Reinvestment Tax Act of 2009 was signed into law, the built-in gains recognition period for S corporations has been **temporarily reduced** from 10 to 7 years for transactions that occur in 2009 and 2010 **only**. Any agency that elected S cor-

poration status prior to 12/31/01 is no longer subject to double taxation if sold in an asset transaction. The same holds true for an agency that elected S status in 2002 or 2003 as long as 1) the firm has been an S corporation for at least 7 years when it sells its assets and 2) if it sells its assets in 2009 or 2010. These sellers will get the benefit of avoiding double taxation and the benefit of a 15% capital gains rate. To the seller, this could equate to nearly an additional \$300,000 in after tax proceeds per each \$1 million in deal value (that is subject to the built-in gains tax). The 2011 increase in the long-term capital gains rate will decrease a seller's after tax proceeds by up to \$50,000 per \$1 million in deal value, and could be higher if the long-term capital gains rate increases beyond 20% (see chart below).

Obviously this is a simplistic overview and does not take into account state tax implications or potential changes to corporate income tax rates. Given the ideal situation where both the buyer and seller are willing to negotiate an asset deal, the owner of an independent agency that is an S corporation beyond the built-in gains recognition period should be able to negotiate the best pricing in terms of after tax proceeds from a sale.

Whether you are an agency owner considering sale or an agency owner considering an acquisition, now is a good time to get serious. Amid our current turbulent economic times, 2009 and 2010 could provide a window of opportunity that could drive after-tax value in a sale or a purchase.



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Assumed Asset Sale	Corporate Level Tax Rate	Shareholder LT Capital Gains Tax Rate 2009 & 2010	Estimated Shareholder LT Capital Gains Tax Post 2010	After-Tax Proceeds per \$1M of Deal Value 2009 & 2010	Estimated After-Tax Proceeds per \$1M of Deal Value Post 2010
S Corp Not Subject to Built-in Gain	0%	15%	20%	\$850,000	\$800,000
<i>minus:</i>					
S Corp Subject to Built-in Gain	35%	15%	20%	\$552,500	\$520,000
\$ Increase in Proceeds to Seller per \$1M of Deal Value				\$297,500	\$280,000
% Increase in Proceeds to Seller per \$1M of Deal Value				29.8%	28.0%

SNL Financial M&A Advisor Rankings

Insurance Merger & Acquisition Deals
1999-2008

Rank	Firm	1999 - 2008 # of Deals	2008 # of Deals
1	Marsh Berry & Co. Inc.	248	31
2	Hales & Co. Inc.	116	29
3	Reagan Consulting Inc.	114	18
4	Mystic Capital Advisors Group LLC	86	16
5	Fox-Pitt Kelton Cochran Caronia Waller	83	6
6	Goldman Sachs & Co.	79	1
7	Credit Suisse (USA) Inc.	55	2
8	Merrill Lynch & Co. Inc.	51	0
9	Philo Smith & Co.	42	2
10	Keefe Bruyette & Woods Inc.	38	2
11	Banc of America Securities LLC	37	5
11	Morgan Stanley	37	0
13	Citigroup Global Markets Inc.	35	2
14	J.P. Morgan Securities Inc.	32	0
15	Merger & Acquisition Services Inc.	30	0
16	Lazard Freres & Co. LLC	23	0
17	UBS Investment Bank	20	0
18	Bear Stearns & Co. Inc.	18	0
18	Lehman Brothers Inc.	18	0
20	Sandler O'Neill & Partners L.P.	17	3
21	Harbor Capital Advisors Inc.	14	0
22	Sica Consultants Inc.	13	0
23	North Bridge Advisors Inc.	12	0
23	Prisco Consulting Inc.	12	0
25	Wachovia Securities LLC	11	0
26	Gill and Roeser Holdings Inc.	9	1
26	Curtis Financial Group LLC	9	0
26	Houlihan Lokey Howard & Zukin Inc.	9	0
29	Raymond James & Associates Inc.	8	0
30	Nexus Group Inc.	7	0

All States // Completed/Pending/Term Transactions
Whole and Asset deals as reported by SNL Financial, January 2009

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Proprietary benchmark statistics on over \$4.5 billion of aggregate brokerage revenue. Used by brokers, insurance carriers, financial institutions, private equity firms and others.

#1 Insurance Management Consulting Firm

Sales management, operational, and financial consulting services to 57 of the Top 100 Brokers and numerous financial institutions.

#1 Insurance Exchange Networks

Own and operate 3 best practices exchange networks comprised of over 175 agencies and brokers representing more than \$3 billion in aggregate revenue and \$27 billion in premium.

#1 Insurance M&A Advisory Firm

- Over 230 transactions with Top 100 Brokers
- 140 Bank Insurance transactions
- Over 550 transactions closed
- Ranked #1 by SNL for the past decade

