

A Word about S-Corporation/LLC Status

by Chris Burand

I find many agency owners have firm opinions regarding the importance of S-Corporations and LLC's. These opinions are not always fully informed. Making the situation worse, their advisors and particularly their accountants are not always fully informed. The accountants continue to make the assumption that all businesses are the same relative to whether S-Corporations, C-Corporations, or LLC's are best. They are particularly not informed regarding cash flows that cause them to make generic recommendations. Here are points every agency owner should consider when choosing their business type:

Taxes

Taxes affect each agency differently for many reasons. Therefore, no universal answer exists. Here are a few generic characteristics:

- C-Corporations:
 - Possibly lower income taxes.
 - Probably, but not necessarily, higher taxes when agency is sold. It depends on how the agency is sold.
- S-Corporation
 - Likely lower taxes, though not always, when agency is sold. Again, it depends on how the agency is sold.
 - Possibly lower income taxes.
- LLC
 - It depends somewhat on the state (no federal LLC statute exists so each state is slightly different).
 - It also depends partially on the type of LLC as several different forms exist.

Taxes Upon an Asset Sale

- C-Corporations:
 - Taxed twice if the sale is not carefully designed.
 - The first tax is a corporate tax.
 - The second tax is a dividend tax or long-term gain as a liquidation distribution.
- S- Corporation

- Taxed once.
- Ordinary tax rate on 1245 assets (computers, equipment, previously purchased books of business) or capital gains on self-created assets.

Taxes Upon a Stock Sale

- C-Corporations:
 - Taxed once.
 - Capital gains tax.
- S-Corporation
 - Taxed once.
 - Capital gains tax.

Most agency sales to outside third parties are asset sales. I've reviewed the publicly traded brokers' 10K's for the last five years and approximately 99% of their acquisitions have been asset purchases. However, the vast majority of internal perpetuation sales are stock sales.

I see agencies being encouraged to switch to an S-Corp to avoid the double taxation upon sale when the only sale that will occur is a stock sale. I get the impression the accountants never even ask the question.

S-Corp Disadvantages Inadequately Considered by Many Attorneys and CPAs

1. All stock is equal. It all has to be common.
2. It is possible in some situations to create voting versus nonvoting but this requires care and is not always applicable. Doing so in the right situation is the right solution but doing this when the situation is not exactly correct may have serious implications.
3. Everyone gets the same distribution as a percentage. This not only enables but it often contributes to poor performance of shareholders who make too much from distributions.

Here is an example of CPA's not understanding agencies but giving generic advice. Maybe an S-conversion does save taxes but an underperforming owner who is enriched by large distributions WILL DAMAGE the agency's value. An agency might realistically go from \$1 million in revenue and \$1.5 million in value to \$800,000 in revenue and \$1 million in value. I have seen it happen many times. The truth is the agency will save a lot in taxes because the value will be so much less. These kinds of decision should NEVER be made in a silo.

4. I can design plans that get around this problem. However, if the agency is a C-Corp and wants to switch to an S-Corp, consider this very serious risk first. It is easier to design plans within a C-Corp that avoid this situation.

S-Corp Disadvantages Inadequately Considered by Many Attorneys and CPAs Specific to Agencies

Outsiders do not understand trust monies. Every state is a trust state (that is a fact you can look up at the National Association of Insurance Commissioners' website). The myth within the industry is that only a handful of states are trust states. Reality is that only a handful of states forbid commingling of funds which is entirely different.

Because all states are trust states, all the cash agencies have at year-end cannot be legally distributed because some of that cash is likely trust money. That means an S-Corp can actually cause financial damage to shareholders.

This happens when the agency has more income than cash. The shareholders have to pay taxes on the income regardless of whether the agency distributed the cash with which to pay those taxes. Legally, the agency likely cannot use the trust monies, even as a "temporary" solution. The idea that taxes are less because the corporation does not pay a tax becomes rather pointless in these situations. Paying taxes without cash is far more punishing than paying an "extra" C-Corp tax by many magnitudes.

Right Solution

Every situation is unique so no generic "right" solution exists. Lots of wrong solutions occur though and most are initiated by professionals giving advice that do not understand the facts and environment. Discover the right solution for your situation by first analyzing the entire situation laying all the facts on the table. If you need to hire someone that knows the insurance industry to educate your attorney and CPA, absolutely do so. Their fee, at least relative to what I charge, is peanuts compared to cost of making the wrong decision.

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