THE TAX CUTS AND JOBS ACT

Here's what it means for you and your firm

TRUSTED ADVISOR

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HEADLINES FROM THE TAX CUTS AND JOBS ACT

- **Federal C-corporation taxes reduced to a flat rate of 21%**
  - This is a significant reduction from the 35% rate currently paid by most C-Corporations
  - The 21% rate does come with a limited deduction on interest, capped at 30% of earnings before interest, taxes, depreciation and amortization ("EBITDA"), and increased limitations on the deductibility of entertainment expenses
- **S-Corporation and LLC owners given a new deduction on business income**
  - Owners of S-Corporations and LLCs ("pass-through entities") can now deduct up to 20% of the income received from their ownership
  - This deduction is limited by income level and is also limited based on the types of business the S-Corp operates
  - "Specified services businesses," which seem to include insurance brokers, have more strict limits on the deduction
  - For agency owners, the limits start at $315,000 in total income for married filing jointly and any deduction is eliminated at total income of $415,000 or above
- **Individual income tax rates are reduced with new limits on deductions**
  - Individual rates have been reduced by 1-4 points across six of the seven tax brackets
  - There are stricter limits on itemized deductions, most notably a $10,000 aggregate cap on the deductibility of state income taxes, local taxes and property taxes
  - The individual tax rate changes do have a sunset provision, reverting back to old rates in the 2026 tax year
- **Some proposed changes were not enacted**
  - Employer sponsored healthcare plan costs are still fully-deductible
  - Although capped, home mortgage interest is still a deductible expense

The major changes in tax law are showcased at left. However, the next question is what these changes mean. How will they impact the valuation of privately-held agencies? Will they drive a preference for a C-Corporation structure? Will they change the M&A market?

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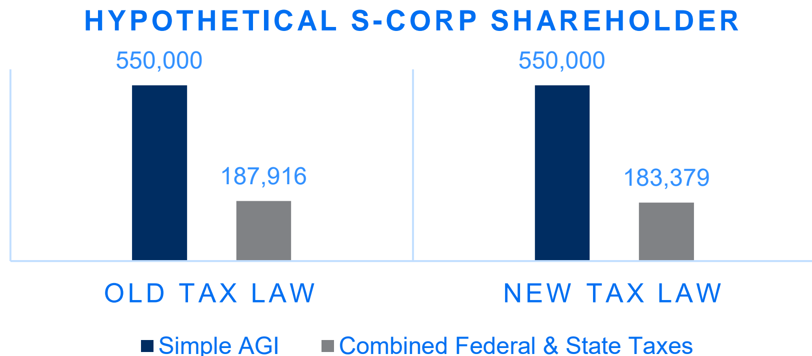
WHAT HAPPENS TO MY AGENCY'S VALUE?

If you are an S-Corporation or LLC, probably not a lot

- These entities were already taxed at individual income tax rates and the changes to individual rates were minor compared to corporate tax rates, containing benefits (reduced rates across tax brackets) and drawbacks (limited deductions on state/local taxes)
- Further, the new deduction on pass-through business income will likely have a minimal effect on most producers / owners with large books of business and / or large ownership positions
- However, because taxes in pass-through entities are based on every shareholder's individual tax picture, it is impossible to say for certain how you and your firm will be affected. We do know that the firms (and owners) most likely to benefit are smaller firms in states with low income tax rates
- The chart below looks at a hypothetical S-Corp shareholder under the new and old tax laws and shows tax savings of just over 2%
    - Assumptions: $400,000 in W-2 income, $150,000 shareholder distribution, 6% state income tax rate, married filing jointly, $10,000 in property / local taxes



If you are a C-Corporation, your valuation is most likely increasing (though this won't be true for everyone)

- The large reduction in federal taxes from 35% to 21% produces more cash flow for C-Corporations (even considering new limits on deductions) and thus, in most circumstances, a higher value
- Why wouldn't this be true for all C-Corporations? Highly leveraged and highly acquisitive C-Corporations will see more limited increases in cash flow (and value) or potentially even decreases. These firms may see an increase in tax expense as the limits on deductibility of interest expense apply and overtake the benefits of the reduced rates
- But it'll take a lot of debt for this to be the case. We believe that, depending on the level of income, firms leveraged above 5.5 x or 6.0 x EBITDA are most likely to be affected by the cap on interest deductibility – levels of debt highly uncommon among privately-held, employee-owned brokers
- In addition, there are also several factors that will partially offset a valuation increase, including:
    - A potentially increased cost of capital
    - A decreased value of the tax benefit of amortization from prior acquisitions
    - Potential marketability issues

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SHOULD WE CONVERT TO A C-CORPORATION?

Under certain circumstances, this can now be an attractive option

- However, for most S-corporations and LLCs, the answer to this question would still be no – on the margin, it still costs less in taxes to get cash out of a pass-through entity than a C-corp (though the gap has narrowed significantly)
- See the analysis at right, which shows, in an agency distributing the vast majority of its profits, that an S-Corp structure can get approximately 14% more after-tax cash to shareholders – even after the tax law reductions for C-Corps
- In addition, there are still benefits to being an S-corporation that haven't been affected by this tax reform bill, such as allowing for an asset purchase structure in a third-party transaction, which can lead to more aggressive valuations from buyers
- However, for firms that do not distribute significant profits to owners, the C-Corporation structure may be advantageous, as they can retain significantly higher amounts of post-tax cash
- With the new tax rates – as shown at right – C-Corps can retain approximately 19% more cash than S-Corps if there are no shareholder distributions
- These non-distribution firms are generally larger and more acquisitive than their peers and they also tend to redeem shares corporately and have more limited direct shareholder purchasing
- For these firms, the combination of (a) a minimal need to distribute profits to shareholders and (b) lower corporate tax rates may make a C-Corporation structure a preferred path

An illustration of C-Corps vs. S-Corps under the old tax laws and the new tax laws

	Old Tax Laws		New Tax Laws	
	S-Corp / LLC	C Corp	S-Corp / LLC	C Corp
Pretax Income	2,500,000	2,500,000	2,500,000	2,500,000
State tax rate	6.0%	6.0%	6.0%	6.0%
State taxes	150,000	150,000	150,000	150,000
Federal tax rate (estimated)	34.0%	35.0%	32.0%	21.0%
Federal taxes	799,000	822,500	784,000	493,500
Total corporate taxes	949,000	972,500	934,000	643,500
Effective tax rate	38.0%	38.9%	37.4%	25.7%
Corporate net income	1,551,000	1,527,500	1,566,000	1,856,500
Corporate cash flow advantage		-1.5%		18.6%
Retained profits	(250,000)	(250,000)	(250,000)	(250,000)
Distributions / Dividends	1,301,000	1,277,500	1,316,000	1,606,500
State dividend tax rate	0.0%	6.0%	0.0%	6.0%
State dividend taxes	-	76,650	-	96,390
Federal dividend tax rate	0.0%	23.8%	0.0%	23.8%
Federal dividend taxes	-	285,802	-	359,406
Total dividend taxes	-	362,452	-	455,796
Effective tax rate	0.0%	28.4%	0.0%	28.4%
After-tax dividends to shareholders	1,301,000	915,048	1,316,000	1,150,704
Percentage of corporate net income	52.0%	36.6%	52.6%	46.0%
Pass-through distribution advantage	42.2%		14.4%	

Illustration above based on estimated tax rates under new laws and old laws. A hypothetical 6% state tax rate is used for corporate, personal and dividend taxes. We have assumed this agency retains $250,000 in cash flow. The pass-through distribution advantage is greater as the percentage of cash flow distributed increases.

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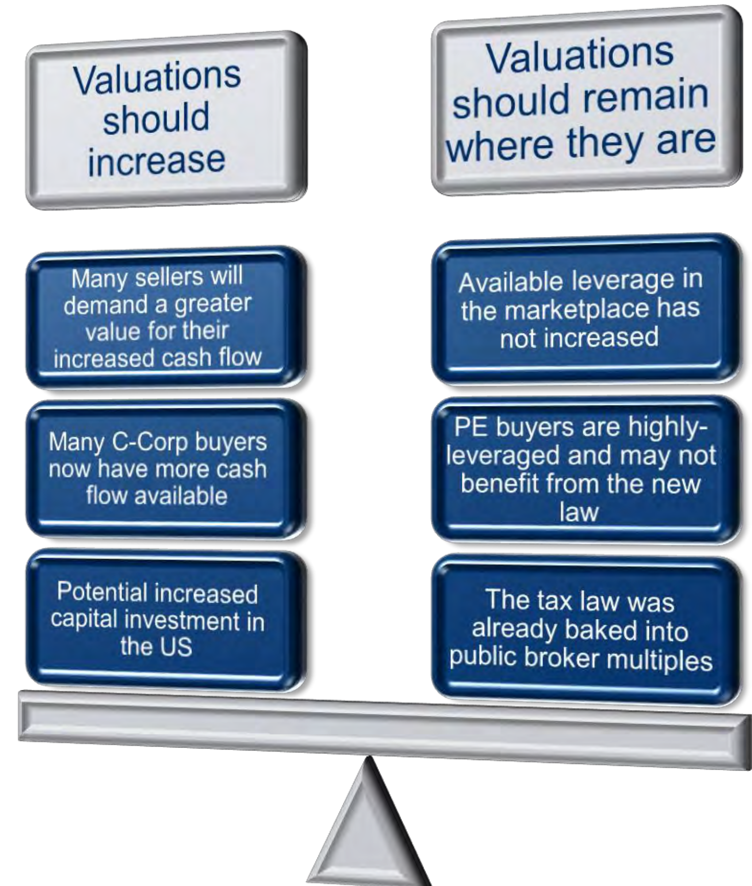
WILL M&A MARKET PRICING INCREASE?

There may be a gentle nudge upward, but we don't expect any dramatic changes

- At the end of the day, there are some factors pushing valuations up as a result of this bill and some factors holding valuations back at current levels (as described in the chart at right)
- We believe that this will result in some minor upside pressure on M&A valuations, but not a step-change in the market
- The biggest factor holding valuations constant is the cap on the deductibility of interest – which will start at 30% of EBITDA and come down to 30% of earnings before interest, and taxes ("EBIT") in 2022. This cap can limit benefits to acquirers with significant debt, fixed assets and/or amortizable intangible assets on the books
- However, we are likely to see a reduction in the premium paid for asset deals. Buyers are still more likely to put higher valuations on asset deals than stock deals because they can deduct the purchase price over 15 years for tax purposes. However, the value of this tax amortization benefit has decreased as the tax shield has been reduced



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