THE VALUATION OF AN INSURANCE COMPANY FOR AN ACQUISITION INVOLVING A SECTION 338 TAX ELECTION

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This paper discusses one possible tax treatment of an insurance company acquisition and the role of the casualty actuary in this process.

Traditionally, the casualty actuary has played a significant role in the accounting practices of the insurance industry through his work in analyzing loss reserves. However, actuarial input to other accounting areas has been more theoretical than applied. While casualty actuaries have written important papers and made valuable suggestions for statutory accounting and annual statement purposes, most actuaries do not work closely with accountants.

The average company actuary is probably reasonably familiar with statutory accounting principles, and has some idea of adjustments that must be made for purposes of generally accepted accounting principles (GAAP). Purchase accounting and tax accounting are probably much more foreign to most casualty actuaries working for insurance companies.

The purchase of an insurer is a challenging opportunity for the casualty actuary, the insurance tax and valuation specialist, and the insurance accountant to cooperate in a multi-disciplinary team. The Section 338 election described herein is only one approach to the acquisition of an insurance company.

TAX ISSUES

Overview of Section 338

A significant provision of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") concerns acquisitions of corporations. Under prior law, certain acquisitions of target corporations generally took the form of either an asset acquisition or a stock purchase. If the buyer acquired the assets from the target corporation, the buyer's basis in each purchased asset was that asset's share of the purchase price. The selling corporation would not recognize a gain on asset appreciation under Section 337 if it liquidated within a time frame provided by statute. The buyer who acquired stock instead of assets, could allocate the purchase price to the underlying assets and liquidate the acquired corporation. If, instead, the buyer did not liquidate the acquired company, the target's tax attributes (e.g. net operating loss carryovers) continued and its assets retained their historical basis.

Congress, in what it perceived to be a correction of several areas of abuse as well as a simplication of existing law, repealed the stock purchase-liquidations of Section 334(b)(2) and added new Section 338. Among the abuses which Congress corrected was the buyer's ability to exercise a high degree of "selectivity" in determining which assets received a favorable "step-up in basis" and which assets avoided a recapture tax. (A "step-up in basis" occurs when the buyer is allowed to increase the tax basis of the target company's assets to an amount equal to its cost of purchasing the target's stock.) Further, under prior law a buyer was permitted to continue the target corporation's tax attributes for a period up to five years after the initial stock purchase while also treating the transaction as though assets had been purchased. This extended "survival" period led both to significant opportunities to combine the target corporation's tax attributes with those of the purchasing corporation as well as major complexities in determining the basis to be assigned to the target's assets or liquidation. Finally, if consolidated returns were filed by the acquiring corporation, the recapture tax liability could be deferred and in certain situations avoided.

In general, new Section 338 provides that with respect to certain stock acquisitions, the purchasing corporation may elect to treat the target corporation as having sold all of its assets on the stock purchase date and as having purchased those assets, acting as a new corporation, on the next day. This "sale" is generally considered tax free to the target corporation to the extent it would have been a sale under Section 337. Finally, the tax attributes of the target corporation, including net operating losses, are not carried over to the new successor corporation.

Under the new rules, it is no longer necessary to form a new company and liquidate the target corporation to get a stepped-up basis; the buyer merely needs to elect to have the stock purchase treated as direct asset purchase. Thus, unlike certain instances under the prior law, outstanding contracts need not be amended and permission from state insurance authorities to treat the stock purchase as an asset acquisition generally should not be needed. Under Section 338, the election applies only for tax purposes.

The election generally applies to "qualified stock purchases" of the target corporation's stock occurring after September 1, 1982. The term "qualified stock purchase" contains the same requirements previously provided in the prior law, i.e., a purchase within a 12-month period of 80% or more of the voting power and 80% or more of the nonvoting stock (except nonvoting, nonparticipating preferred stock) of the target corporation. The deadline for electing Section 338 is 75 days from the date of acquisition. This has been administratively extended to the later of 75 days after the acquisition or 30 days after the IRS issues regulations. This means that decisions generally must be made more quickly now than in the past where, under prior law, a buyer could wait up to two years before deciding whether a stepped-up basis was desirable. Once made, the election is irrevocable.

Tax Implications Resulting from the Election

A Section 338 election is particularly beneficial where the purchase price exceeds the book value of the target. Under this election where the purchase price of the stock includes a "premium" over book value of the underlying assets, the basis in the acquired stock, including unsecured liabilities assumed, may be apportioned to all the acquired assets based on their rèlative net fair market values. In this process appreciated property obtains a stepped-up basis thereby providing an opportunity to obtain higher cost recovery and amortization deductions. The step-up also serves to reduce potential taxable gains on future dispositions of such assets. It should be noted that assets that have depreciated in value will be written down thereby producing the opposite results. Further, transactions between the purchasing corporation and the target or target affiliate for a period of one year both before and after the acquisition date must be treated as if included as part of the stock acquisition unless the sale by the target corporation is in the ordinary course of its trade or business or one of several other limited exceptions are met.

The assets of the target corporation will be treated as sold (and purchased) for an amount equal to the grossed-up basis of the acquiring corporation in the stock of the target corporation on the acquisition date. "Grossed-up basis" is a tax concept and was devised for situations where less than 100 percent of the target's stock is purchased. If the purchasing corporation owns all of the target corporation's outstanding stock, the grossed-up basis of the target corporation's stock is its cost basis. If the purchasing corporation acquires less than 100 percent of the target corporation's stock, an adjustment must be made to the basis of assets acquired to reflect the continued interest of minority shareholders. The formula used to determine the grossed-up basis provides that this amount is to be adjusted under the regulations to be issued for *liabilities of the target and other relevant items such as recapture* tax liability. It should be noted that pending legislation, specifically H.R. 4170, "The Tax Reform Bill of 1983", provide changes in the formula used to determine the grossed-up basis.

Significant tax benefits are achieved where identifiable amortizable intangible assets are acquired. An intangible asset can be generally defined as a property or property right which does not have physical existence, but which can be expected to produce income in future years.

Intangible assets can be more narrowly categorized as identifiable and unidentifiable. To be considered an identifiable intangible asset for federal income tax purposes, the intangible asset should be "identifiable" with specific rights, properties, relationships, contracts, or other definable source of income potential. Common examples of identifiable intangible assets are patents, trademarks, franchises, equity in favorable contracts, and certain types of customer relationships.

Unidentifiable intangible assets, as the name implies are valuable properties whose source of income potential cannot be pin-pointed to a specific source. These assets are often referred to for tax purposes as goodwill (defined more narrowly as the propensity of satisfied customers to return to the old place of business resulting in an "excess earnings" potential) and going concern value (defined as a "turn key" premium for an established enterprise which can be expected to conduct a continuous and reasonably profitable business despite a change of ownership).

To justify that an intangible asset is amortizable, a taxpayer moreover, must demonstrate that the asset has a life of limited duration and that this life can be estimated. Examples of amortizable intangible assets may include customer and service lists, subscription lists, leasehold, data base, future profits in existing company contracts, and the sales force.

With respect to property and liability insurance companies, amortizable intangible assets which the target corporation may possess include the following:

Value of future profits in the loss reserves. This asset may exist because, for statutory purposes, companies are required to establish loss reserves at undiscounted values. It appears that the acquiror could take into consideration anticipated future investment income as an amortizable intangible asset.

Value of future profits in the unearned premium reserve.

This asset represents the potential future investment income and underwriting profits on the unearned portions of policies already written.

Future profits on renewal business. Often referred to as either Book of Business, Expirations, or Dailies, this asset is the present value of the future profit stream associated with renewals of the current book. If the target company can accurately project it's renewal business, underwriting profits on renewals, and future investment income associated with related reserves, then this may represent an amortizable intangible asset.

In the case of a life insurance company, identifiable amortizable intangible assets may include the following:

Future profits on business in force. This represents the present value of future profits on current business. The determination of the value of this asset requires actuarial analysis of such key items as investment income, assumed rates of interest, lapse rates and mortality experience.

Agency force. The value of the agency force is akin to the present value of future profits produced from new policyholder premiums. Profit margins from future sales may be based on actuarial assumptions similar to those made in valuing current business in force. However, an additional assumption must be made on the volume and product mix of future sales. Whether this asset is susceptible of being separately valued and amortized for tax purposes can be addressed only on a case-by-case basis.

Policy loans. Life insurance companies are required to make loans to policyholders at rates well below the current market rate. No rulings or decisions have dealt with the values to be assigned to this category of asset, but assigning a face value with an offset of an equivalent amount of reserves appears to be in accord with the statute rather than discounting the value of the loan with a possible increase in income when the loans are repaid.

Unresolved issues. In Rev. Proc. 83-57, the Service announced that it is extensively studying the consequences of an acquisition of a life insurer followed by a Section 338 election. Accordingly, the Service assumed (among other issues) a no ruling position regarding:

- whether life insurance reserves may be treated as unsecured liabilities for purposes of determining allocable basis, and

- whether a portion of the purchase price is properly allocable to insurance-in-force.

When the results of the Service study will be made known cannot be predicted at this time. However, suffice it to say that resolution of these issues may not occur in the foreseeable future.

Moreover, numerous issues as to the manner of making the election, allocation of the purchase price among others, remain unresolved. This is evidenced by the statute that contains many references where Congress specifically authorizes the Treasury to promulgate regulations to amplify or implement this provision.

Evaluating the Trade-Offs. While an election pursuant to Section 338 may produce fairly significant tax advantages through the amortization of intangibles, the election is not without tax and economic costs. Also, the extent to which net operating loss carryovers may be terminated should be included. Depreciation and investment tax credits claimed by a target corporation prior to the acquisition may be recaptured as of the date of the acquisition. Depreciation recapture is a limitation on the amount of long term capital gain arising on the sale of certain depreciable assets. Gain on the sale of such property is treated under recapture as ordinary income to the extent of depreciation taken as a deduction in prior years.

The assets with respect to which such recapture would arise would be valued at their fair market values as of the date of acquisition and such value would be used prospectively over several years in calculating depreciation and investment tax credit.

Recapture income and investment tax credit recapture from a Section 338 election can not, except for limited exceptions, be included in a consolidated return of either the seller or the purchasing corporation. If the target corporation was not a member of an affiliated group, the recapture income is included in a short period return (i.e. a return for less than one year) which would also include the target corporation's income up through the date of acquisition. If the target corporation is a member of an affiliated group, a separate return, which reflects the recapture tax liabilities, is required.

Tax Planning. It is clear that opportunities exist to ascribe values to the amortizable intangibles not found on the statutory statement. Proper tax planning dictates that early consideration of these issues be incorporated into the negotiations. This planning must be done by a team of qualified tax professionals. As we shall see, there is ample opportunity for a casualty actuary to participate on this team.

THE ACTUARY'S ROLE

In order to comply with a Section 338 election one must value all assets as of the acquisition date. At first this does not seem to be an actuarial problem since most assets may be valued by auditors and appraisers. There are various methods based on cost, depreciation and market value that can be used. Actuaries, on the other hand, are typically concerned with future events. How many losses will occur next year? How will the reserves run off? But, as we'll see shortly, the same issues and techniques that an actuary deals with in resolving "standard actuarial problems" must be dealt with in valuing certain intangible assets not found on an insurance company's annual statement.

For purposes of this discussion we will consider two broad categories of assets. The first category consists of the ones usually found on the asset page of any company's annual statement. These include stocks, bonds, cash on hand, computers, accounts receivable, etc. They are reflected in policyholders' surplus. In addition, the annual statement discloses elsewhere certain non-admitted assets excluded from surplus. Considered together we will refer to these assets as statement assets. Most of these assets the Company or its auditor can value.

Since the annual statement is the basis for calculating taxable income, asset valuations for a Section 338 election logically should begin here. Of course there are complications since the annual statment was not designed for this purpose. Statutory accounting requires certain types of valuations. In valuing the statement assets for tax purposes adjustments must be made. Bonds at amortized values should reflect market values as of the acquisition date. (A word to the wise: The market value shown in Schedule D is often not a true market value.) Non-admitted assets also must be added back to the balance sheet at market values. Stocks must be set at market value as of the valuation date. All these adjustments are typically performed by auditors and appraisers.

The other category of assets is not displayed on the annual statement. These are the intangible assets where actuarial issues such as the run-off of past, present, or future business are a critical ingredient in the valuation process and have significant ramifications in regard to future tax treatment. Identifiable and unidentifiable intangible assets typically exist in any insurance company for three reasons:

1. Companies sell insurance.

2. Statutory accounting requires that insurance companies keep large sums of money, or liquid assets, available to pay claims.

3. Funds held can earn money.

Consideration of intangible assets is critical for the buyer and seller in negotiating a purchase price.

For a Section 338 election **all** assets whether tangible or intangible, amortizable or non-amortizable, should be valued. Furthermore, the IRS to date has acknowledged in numerous private rulings that certain intangible assets may be amortizable where the taxpayer meets his burden of proof of three critical requirements:

1. The asset must be severable from unidentifiable goodwill; that is, the specific source(s) of future income potential must identifiable and capable of being separately valued;

2. The asset must be a "wasting asset"; that is, the economic viability of the identified asset must be of limited duration, such that its value declines over time; and

3. The remaining period of economic viability must be capable of being estimated within reasonable business accuracy.

It is here that an actuary can pitch in. Working closely with the tax specialist, actuarial expertise can be used in several ways. He can provide formulas to evaluate. He can review historical data to project runoff of current or future premiums and losses. He can analyze historical cash flows and project future contingencies.

EXAMPLES OF INTANGIBLE ASSETS OF A TYPICAL INSURANCE COMPANY

As mentioned, there are at least three potentially amortizable intangible assets common to every insurance company. The first of these deals with the loss reserves. We refer to it as "Future Profits in the Loss Reserves". Most loss reserves are carried at the full amount needed to settle all losses, reported or not, that have occurred to date. To the extent that the actuary can assist his client sustain the burden of proof that the reserves are identifiable with a specific group of insurance exposures; that the life of the reserves is of limited duration; that the runoff (or consumption) rate of the reserves can be estimated with reasonable accuracy and that appropriate projections of anticipated investment income can be allocated to the reserves in question, "Future Profits in the Loss Reserves" may be valued and amortized for tax purposes.

The second of these deals with the "Future Profits in the Unearned Premium Reserve". The unearned premium reserves will earn interest while they are being held by the insurance company. In addition, as the unearned premium reserve expires, the losses and expenses incurred may be less than the premium earned and produce an underwriting profit. The ability to earn investment income and underwriting profit form a valuable identifiable intangible asset. Again, to the extent that the actuary can assist with valuing this asset, and demonstrating that it is a wasting asset, where remaining economic life can be reasonably estimated, it may be amortized for tax purposes.

The third identifiable and potentially amortizable intangible asset is the "Future Profits on Renewals". A company can reasonably expect to renew a certain portion of its current book each year. These renewals will generate reserves and these reserves will possess the intangible assets described above. To see that this asset exists one need only note that often an insurance company will be bought solely to acquire its book of business.

The techniques applied in valuing these intangibles is beyond the scope of this paper. The literature abounds with such. Also, most companies need tailored methods. A clear understanding is necessary for evaluating the above assets as well as the unidentifiable intangible assets. Rather than try to give recipes we'll discuss concepts underlying these valuations.

The actuary is very familiar with the main tool needed to evaluate many intangible assets - projection of cash flow. Whether we are dealing with losses that have already occurred, or losses that will occur in the future, premium, or expenses, one must project not only the amount that a company will receive or pay but also the rate of payment. The next step is to determine an appropriate investment rate. This investment rate need not be based on a company's investment portfolio. Since stocks and bonds reflect market value for a Section 338 election the historical interest rate is already removed. U. S. Government bonds give a reliable indicator of the available interest rate. A mix of U. S. Government securities, with appropriate durations, can be used for an average return. It is also possible to incorporate a mix of tax-free municipals. Other sources are available.

A different discount rate may be needed for projected profits. If projected investment income is to be used to make future payments then the discount rate should equal the investment rate. However, profits available for stockholders should be discounted with an appropriate rate for the company.

Often the discount rate applied to future profits is greater than the projected investment yield, reflecting risk considerations. One choice of risk-related discount rate is given by the Capital Asset Pricing Model (CAPM). It's easy to use, it's objective, it can be tailored to a specific company, it's consistant with the government bond rate and it is often used for tax valuation purposes. Other choices also exist.

SOURCES OF DATA

To project the above cash flows a large amount of data is needed. Federal income taxes are based on the annual statement so this is the place to start. Schedules O and P offer information on loss payment rates. The five-year history is a good source of calendar year premiums, earnings, and expenses. The other exhibits are also useful. The amount of additional detailed data necessary is an important judgment for the actuary and the tax specialist.

Knowledge of company operations is critical. As with any other actuarial area, changes in company operation may inhibit the usefulness of historical data. Here interviews are important.

Senior company management will be helpful in pointing out problem areas. Annual reports, 10-K's and even special data requests may also be helpful. The information developed may suggest adjustments be made to historical data to reflect new circumstances prior to making any projections. However no such adjustment should be made unless evidence (e.g. new reinsurance contracts, etc.) is available to support the adjustment.

Valuing the future profits on renewals requires special care. The main problem here is to estimate the portion of business that will be renewed year to year. For this purpose most companies rely on runs that start with a fixed block of business. The portions of this block renewed in succeeding years should be shown on a "dollar" and a "number of policies" basis. From these runs, future renewals of current business are predictable. There is however, a pitfall. Due to intense competition in recent years, many companies have been canceling policies and rewriting them on different terms. Often a company will show this transaction as a cancellation, and a new writing. However, this is in effect a renewal and it is important to count it as such.

ADDITIONAL ANALYSIS

Before starting to evaluate intangibles some preliminary considerations should be addressed. It is important that current loss reserves be adequate and not redundant, so a reserve study may be necessary. The actuary must consider the effects of any restatements in choosing his parameters. For example, a severe reserve deficiency will not only require an increase in reserves. It will also be necessary to adjust historical loss ratios and earnings for this deficiency. If this isn't done projected loss ratios will probably be too low, and projected earnings will probably be too high. A redundancy has the opposite effect.

Once the valuation of the intangible asset is complete, an amortization schedule of the asset should be prepared. Usually amortization formulas, from compound interest theory, are sufficient. However, due to certain statutory accounting principles, straight amortization formulas may distort the depreciation schedule. For example, since statutory accounting requires an immediate writeoff of deferred expenses a projected profit stream may start off negative in the early years and turn positive later on. In this case, use of a present value type of amortization would lead to results that aren't useful for balance sheet purposes. In these cases it might be better to choose a straight line depreciation schedule. Another alternative is to combine two or more profit streams from different intangible assets, so that the net profit stream is positive. Ongoing consultations between the actuary and the tax specialist may be necessary to select the most appropriate method.

Since projections of the future are used, and since insurance is a risky business, some sensitivity analysis may be required. Often an actuary estimates probabilities of different parameters in order to arrive at expected values. For documentation purposes it is probably better to work with an expected scenario and choose a discount rate that suitably adjusts for the risk involved. Since CAPM incorporates the risk of an insurance company this provides another argument for its use.

OTHER ACTUARIAL CONSIDERATIONS

There are other factors to consider in a Section 338 election. Other intangible assets may exist. A company-owned agency force, relationships with independent agents, or the right to participate in a pool might generate future profits. In addition, some assets are hard to classify as either tangible or intangible but still should be valued. Computer software is a good example. One must estimate the effect of income tax on projected future profits. Subsidiaries offer another complication. A similar analysis of each subsidiary may be needed.

FINAL ACTUARIAL REPORT

When all the analysis is completed a final report is a must. All computations should be carefully documented along with the selected methods and parameters. Documentation of data sources and parameter estimation must be included. If historical data has been adjusted this must also be cited. Schedules of amortization of intangible assets should also be included.

This document should be kept on file should the need for it arise. Again, consultation with the tax specialist is mandatory.

One cannot over emphasize the importance of this final actuarial report. Accountants and valuation specialists must have an explanation of all the factors contributing to the analysis in order to proceed with the Section 338 election. Equally important, in the event of an IRS audit, documentation of results is crucial to sustaining the taxpayer's burden of proof. Remember, what's obvious today will probably be incomprehensible three years from now. It is better to over-document today than not to be able to reconstruct your thinking at an IRS audit.

CONCLUSION

In summary, the actuary can play a vital role in helping to secure significant tax benefits in connection with the purchase of an insurance business. Working closely with tax professionals, he can use his traditional actuarial tools and expertise to help resolve complicated tax and valuation issues.