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ACCOUNTING FOR MERGERS AND ACQUISITIONS

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Recorder: THOMAS E. SKILLMAN

- o American Institute of Certified Public Accountants (AICPA) activity in purchase accounting
- o Merger/Acquisition accounting
- o Assumption reinsurance
- o Minority interest accounting alternatives
- o Foreign mergers, acquisitions, and joint ventures accounting
- o Tax considerations in structuring mergers and acquisitions

MR. RICHARD S. MILLER: Generally, there hasn't been a great deal of Purchase Generally Accepted Accounting Principles (PGAAP) accounting issue activity beyond the original pronouncements of the Academy and the original audit guide. There has been little activity at either professional level. The Academy committee task force on PGAAP has yet to meet and does not plan to until something from the AICPA causes us to have to meet. As to the AICPA, contrary to the situation in the last three years, they do plan to meet next month. Maybe something will result from the draft paper which has been produced.

The intent of PGAAP is to produce a balance sheet at the acquisition date and income statements thereafter which have no gain reported in the income statement relative to the purchased block of business other than deviations from the assumptions that were incorporated into the PGAAP plus some level of income comparable to what is expected on current issues. This has led to extremely large revaluation differences between the historic GAAP (HGAAP) and the PGAAP reserves, and a fairly substantial value of business acquired asset -- an intangible which has to be written off over some period. This asset value gave a great deal of comfort to the purchasing company as a validation of their judgment on the purchase price paid. Between the value of business acquired asset and the asset resulting from the step-up in basis, the balancing item -- goodwill -- was not too large. The goodwill is usually written off over forty years. The normal desire is to put as much

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value into the goodwill item as possible because the alternative characterizations usually will require amortization over a period of less then forty years.

The purchaser is typically going to determine how PGAAP is structured. Because of recent experience, I am of the opinion that there is no value added by PGAAP accounting from a management standpoint, although accounting rules may dictate that it must be done.

From a management standpoint, there is some advice I'd like to give. Purchase accounting, taken to its logical ends as called for in the literature, completely destroys historical trend patterns used by management in its evaluation of how the company is doing. The wrenching change between product line earnings patterns before purchase accounting and after purchasing accounting leaves management naked to unexpected results. This is not serving management well. A way around this might be to report your results in separate segments -- a prepurchase line of business, and a post-purchase line of business. In this fashion, one can isolate the earnings results by product line properly and show the effect on current earnings of the purchased block and of the new business block. We have not done this, although we did consider it. We have become increasingly dissatisfied with the lack of information, and we may yet split the purchase block out and start reporting it separately.

With the reduction in the value of a Section 338 liquidation due to a new Internal Revenue Service (IRS) proposal, I wonder whether the effort involved in doing PGAAP and the disruption of management information is worthwhile. Actuaries and the accounting profession should take another look at the value of pooling as an alternate to purchase accounting.

One of the primary advantages we received from purchase accounting was not quite expected. When we revalued our assets in 1980, there was a 20 percent short-term and 14-15 percent long-term interest rate environment. The reduction we took on the asset side of the balance sheet was rather astounding. As a result, however, we found ourselves in a situation where capital gain opportunities quickly presented themselves. The opportunities to take realized capital gains into income has proven to be irresistible because of the disappointing earnings coming out of operations.

The peculiarities of the accounting rules, which allow us to take realized capital gains into income while ignoring unrealized capital losses, is probably an imbalanced treatment but, nonetheless, is one of the primary advantages we found from PGAAP.

I encourage you to resist any effort to assign a value to the distribution system, the value of the company's name, or any other similar pure intangible within the GAAP accounting balance sheet, even though for purposes of presentation to the federal government under a Section 338 revaluation, a different answer may be appropriate. For intangible items, the write-off period for the value assigned may be extremely short. The write-off of the value of an agency system over the future lifetime of the agents present at the date of purchase is rather rapid.

I urge you to do asset revaluations in a manner which will automatically produce the by-asset accrual of discount that is called for under PGAAP. The mechanics of keeping the balance sheet consistent with the original assumptions call for the ability to calculate accruals at the detail level. This is because the disposition of assets should trigger rather substantial amounts being accounted for in the accrual of a discount item. We found this particularly difficult in the mortgage portfolio but were able to handle it in the securities and bonds portfolio.

Within the PGAAP structure, a large item will be a number called the value of the business in force or something similar. Accounting theory calls for this to be recorded on the asset side of the balance sheet. Occasionally it has been permitted to be buried into the reserve account as an offset to the liability item. That latter technique is what Southwestern used when we arrived at our values. We did what amounted to a gross premium valuation and used that number as the liability. The discount rate used to discount future statutory profits will usually be a risk rate of return, which is considerably higher than the investment rate of return used in the assumptions and probably higher than the investment rate of return used in valuing the assets. Using that high discount rate is most desirable in that it causes income from the asset side of the balance sheet rather than the pure write-off which most intangibles produce.

How to handle policy loans has been particularly troublesome relative to revaluation of the assets. Policy loans as an asset have no literature, no precedent, and no marketplace in which to value them. While you might be able to obtain a reasonable interest rate, there is little literature or recorded experience on cash flow of the liquidation relative to policy loans. Therefore, trying to put a market value on policy loans becomes extremely difficult both theoretically as well as practically. The policy loan account has been used typically to determine the investment rate to be used in valuing the benefit reserve side of the balance sheet.

Under the current tax situation, I expect purchase prices will tend toward HGAAP book values. My personal preference would be for not applying substantial PGAAP other than goodwill entry necessary to produce a shareholders account equal to the purchase price. There may be situations where the materiality standard might permit that approach, but usually the current accounting rules would not permit it. The PGAAP adjustments should be kept as simple as possible and be such that you can extend them backwards in time so that revised pro forma PGAAP earnings can be put together for management purposes.

Again, once you have gone through PGAAP, the emerging earnings on the old block of business will often become controversial within the company's management. I suggest you attempt to account for the purchased block separately from the business issued subsequent to purchase so that you can keep track of the actual effect of PGAAP.

MR. STEPHEN D. BICKEL: The general theme of Mr. Miller's remarks is that purchase accounting does more harm than good. What do the other panelists think about that?

MR. ROBERT W. STEIN: There is no doubt that doing a PGAAP valuation is a big project. I'm not so convinced that it isn't useful to management for evaluating how they're performing prospectively, quite aside from the fact that the revaluations will continue to be required. Economically, the historical bases of the assets and liabilities of the acquired entity are irrelevant to the new owner. The new owner should not evaluate performance on the basis of historical investment values which are not relevant to the new owner's situation. The whole objective of purchase accounting is to record the current market value of the assets and liabilities, so future operations reflect the economics which result after the date of the acquisition. There is some value in PGAAP from the standpoint of enhancing the analysis of the buyer's position with respect to the acquired entity.

MR. KEITH A. TUCKER: It seems Mr. Miller is saying that it is important, when structuring the manner in which you do your purchase accounting for an acquisition, to close off that book of business because you don't want the management of the acquired company to be judged on the basis of a pricing decision made by the acquirer. Management should be judged upon new business being produced. If the new business results are combined with the purchased business results, you don't have a meaningful tool available for measuring management's performance on new business. The performance of the purchased block is a result of a pricing decision, be it good or bad, of the acquirer and is not a measure of management's performance.

MR. BICKEL: There is no doubt that applying PGAAP does some harm. Some of the companies we have bought will not believe that the PGAAP earnings are the real earnings. They try to use HGAAP earnings in their performance plans even though those earnings are not meaningful to us.

While it is definitely confusing, revaluation is still necessary. The purpose of purchase accounting is to prevent the acquirer from producing "instant earnings" the year after the purchase, by selling off assets which were undervalued historically. Failing to revalue reserves would frequently result in accelerating future profits. The investment income would be pumped up because of revaluing the bonds to market, whereas reserve increases and required interest would stay the same. That would produce a distorted picture.

I would like to ask Dick some questions. Have you actually written off the value of the agency system in some situations? We have included that in goodwill, with a forty-year straight-line amortization.

MR. MILLER: Yes, we have done it twice and are in the process of doing it a third time. In particular, debit business is of questionable value if you assume that you immediately lose the complete debit agency force. If the men are not there to service it, presumably your lapse rates for the next few months are going to be astronomical.

Any valuation of debit business by implication assumes that the servicing system and the underlying distribution force will be there to service that business. The value may be expressed as a value per thousand or lump-sum value of the business in force, but it is indeed largely a value of the distribution system. We also computed a value of the agency force at Southwestern Life, a managerial career shop, and put that into our 334(b)(2) valuation. Its use was not included in the original accounting by PGAAP, which included the value of the agency force as part of the goodwill.

MR. BICKEL: I understand that you did that for tax purposes. For financial reporting purposes was the value of the agency force part of the goodwill?

MR. MILLER: Yes.

MR. BICKEL: That's the same way we treat it. How did you define the benefit reserves, and what profits were being discounted to determine the cost of insurance purchased?

MR. MILLER: Practicality often dictates over theory. In our case, we had in place a historical GAAP valuation system, which could produce the equivalent of gross premium valuations as long as the future profits were discounted at the same rate as the investment return assumption. We did not have the capacity to separate those two. We put together a PGAAP valuation which obtained a new profit premium. The present value of that premium was the value of the business in force. The preferred treatment is to take most of that number and set it up on the other side of the balance sheet as the value of business in force. Since it was going to be amortized with the actuarial assumptions inherent in PGAAP, we just netted it into the benefit reserve.

MR. BICKEL: The definition of the profit premium would be the excess of the gross premium over what?

MR. MILLER: The excess of the gross premium over the recalculated natural premium.

MR. BICKEL: Is the natural premium calculation determined as of the date of issue of each contract?

MR. MILLER: That's correct.

MR. STEIN: No, it's from date current forward.

MR. MILLER: But it worked from the statutory reserve.

MR. BICKEL: I see. The statutory reserve plus future natural premiums would be sufficient to mature the benefits, and the excess of the gross premium over the natural premium is the profit which is discounted at a risk rate of return.

MR. MILLER: It wasn't discounted at risk rate of return.

MR. BICKEL: You would have used a risk rate of return if you had had the time.

MR. MILLER: We would have if we had had the mechanical capacity to do it.

MR. STEIN: Does that imply that, at the date of the purchase, the reserves are equal to the statutory reserves?

MR. MILLER: No. The reserves were equal to statutory reserves minus these values of insurance in force.

MR. STEIN: But if you were to split that balance between a benefit reserve liability and a cost of insurance asset, the liability side of the balance sheet would equal statutory reserves?

MR. MILLER: That is one of the reasons we didn't split it.

MR. STEIN: I think that is a good reason for not splitting it.

MR. BICKEL: In nonmaterial situations, we've used many methods, including the one you prefer, i.e., using the HGAAP reserves and making some other goodwill-type adjustment. The method we have used most recently is to calculate a net premium from date of issue, which would mature the benefits under current assumptions. Once that net premium is determined, we can calculate a benefit reserve. The excess of the gross premium over the benefit net premium and a normal profit allowance, e.g., 10 percent of premium, is then determined. The present value of that excess premium is the cost of insurance asset.

MR. STEVEN H. MAHAN: I want to comment on the idea of using the PGAAP earnings to evaluate the performance of management versus the idea of dividing off profits of the old block and assuming that isn't the responsibility of new management. I don't think that assumption is entirely correct. Management can make some decisions which would enhance new issues and tear apart the old block.

MR. MILLER: We did tear apart our old block.

MR. STEIN: How are the tax attributes of the assets and liabilities reflected in the PGAAP balance sheet?

The underpinnings of all the PGAAP processes is APB 16, which defines how to do the revaluation. It indicates that, as part of the fair market value assessments of the acquired assets and liabilities, the tax attributes of the items are also to be considered. This usually results in the elimination of historically generated deferred tax liabilities and recalculation of adjustments to be added to the bases of the individual assets and liabilities. That is, to the extent that the PGAAP basis of the assets and liabilities differs from the tax basis of the assets and liabilities, there will be either more or less book income than tax income. The different flow of income on a tax and a book basis is identified, and the related tax effect is estimated and recorded as part of the specific assets and liabilities.

Generally, the assets and liabilities are examined and compared with the tax basis. Those differentials are tax effected and written into the basis of the assets in the PGAAP financial statements. As a result, the basis of the assets, as recorded through PGAAP, reflect the taxable status of those items. While this is conceptually the same whether there is a step-up in basis for tax purposes or not, the impacts are somewhat different.

In the event there is not a step-up in basis for tax purposes (meaning that the tax basis of the assets and liabilities of the acquired company remain the same after the acquisition), there typically are substantial differences between the tax and GAAP bases of the assets and liabilities. In the case of invested assets, a common situation recently has been that the fair market value of the assets is less than their historically recorded tax basis. That difference would be quantified as the basis of the asset would be changing for GAAP but not tax purposes. That differential then is tax effected by applying the appropriate tax rate to the difference and recording that amount as part of the GAAP basis.

On the benefit reserve side, the PGAAP reserves are likely to be substantially different than the tax basis reserves. That was clearly the case before the current tax law, where 818(c) reserves were common for tax purposes. To the extent that that's the case, there will be greater taxable income than GAAP income as the reserve differential flows through taxable income in the future. It would not flow through GAAP income. As a result, a tax liability is established as part of the total benefit reserves to recognize the tax effects of the differences in taxable future income and GAAP future income.

With respect to the value of insurance in force, in the no step-up in tax basis case, there is no corresponding tax value. The GAAP value of the insurance in force is compared to a zero tax basis. As a result, the entire amount must be tax effected. Taxable income will exceed GAAP income (as taxable income will not be reduced by the amortization of the GAAP value of insurance in force), and therefore, the value on an after-tax basis is reduced.

In the event there is a step-up in tax basis, the current fair market value is used by the tax authorities and becomes the tax basis of the acquired entity. The old book basis is lost, and we use a current valuation for tax purposes as well as for PGAAP accounting purposes. On the invested-asset side, it's typical that the difference between the values for PGAAP and for tax purposes is not substantial, and it is likely that there would not be a material tax adjustment.

For the benefit reserves, of course, there still is a difference between the tax reserves and the GAAP reserves. In this case, the same kind of tax effecting is done as without a step-up. To the extent that the tax reserves are larger than PGAAP reserves, that difference would be tax effected, and those liabilities would be provided.

Under the step-up situation, a corresponding tax item is present for the value of insurance in force. However, it's common to put more into the tax value of insurance in force, so it varies from the GAAP amount. The value of insurance in force on a GAAP basis can be viewed as the present value of a portion of future PGAAP profits. The tax amount typically is based on the present value of statutory profits. These are different calculations, and it's common for the tax value to be substantially larger than the book value. Again, that differential is measured and tax effected and those differences are recorded in the PGAAP balance sheet.

The way these calculations have been described, they sound fairly simple to compute and conceptually they are. All one does is to compare the amounts of the assets and liabilities and the book basis with the corresponding tax items, apply the appropriate tax rate, and incorporate that tax effect into the basis of the individual assets and liabilities.

There are, however, some differences of opinion as to how to do some of those calculations. There was always a big question under the old law as to what tax rate to use. For the assets, it was not too difficult to get to a capital gains rate. On the other ordinary income items, anticipating what tax rate to use in these calculations was always the subject of some debate. I'll identify three alternative practices, two of which produce the same net balance sheet. The other produces a substantially different balance sheet.

One approach would be as I have described so far. The benefit reserve is kept separate from the value of insurance in force, and the benefit reserves and tax reserves are compared and tax effected. The same can be done with the value of insurance in force for the GAAP and the tax amounts. No discounting takes place, which fails to recognize that, to the extent tax reserves exceed GAAP reserves, the tax on the excess of future taxable income over book income is going to be paid out in the future. This "no discounting" approach, is consistent with what is typically done for the invested assets. The tax effects related to the invested assets seldom are discounted.

A second alternative would be to compare the net PGAAP reserve to the tax reserve. If discounting is not used, this will produce the same net result as the first method. The bases of the assets and liabilities will look different because a greater excess of tax reserves over net book reserves is created, but that is offset by a corresponding adjustment for the effects of the tax value of in-force business. Failure to discount those tax attributes produces the same net balance sheet as does the first method.

However, some believe that these tax effects should be discounted. For example, in a step-up situation, if the net GAAP reserve can be compared to the tax reserve, some believe that it is appropriate to discount the related tax effects, which would reduce the liability adjustment. As the net reserve has been used to do the reserve tax effects, the tax value of insurance in force remains alone in the comparison of book and tax bases. There is a tax balance and no corresponding book balance, because it has been used in the net book reserve comparison. That tax deduction would generate tax savings, and some believe that those tax savings should be discounted and recorded at a discounted value as opposed to the undiscounted value.

These discounting approaches recognize that the taxes will occur in the future, and in that sense, it's logical to discount the amounts. However, failing to do so in the invested asset calculations, for example, introduces an inconsistency. In some cases, only the tax effects of the tax value of insurance in force are discounted. If this technique is used, a much reduced asset results, and therefore, a smaller amount requires amortization against future PGAAP income. This increases future PGAAP income, as the effect of that discounting has been shifted to goodwill.

The general concept is relatively straightforward, but the discounting can introduce substantial differences in the balance sheet and create major impacts on PGAAP income. Also, there are questions as to the appropriate discount rate. Should it be a net-investment earnings rate? Should it be a risk rate?

Opinions on the appropriateness of discounting vary. It properly recognizes that these tax effects will flow through over a good many years. However, I am opposed to using discounting inconsistently. That is, if the tax attributes are going to be discounted, they ought to be discounted as they relate to value of insurance in force -- benefit reserves, invested assets, all of the balance sheet items -- because all of the tax effects are going to emerge over time. When discounting is applied only to the tax value of insurance in force, it produces a situation which has the possibility of substantially increasing post-purchase income on the acquired block.

After the amortization of these tax effects is completed, the balance sheet is composed of items that could be identified as the basic pretax fair-market values and elements of tax effect. APB 16 requires that these effects be included in the asset and liability balances. If that is done, however, future reserve changes will have a tax effect piece in them. Also, the amortization of the value of insurance in force and investment income will have a tax piece in them. Thus, they will be flowing through pretax income after the acquisition. That causes some difficulties in analyzing what's happening as, in effect, there are tax provisions in the pretax line items.

While APB 16 does not specifically allow for the separate identification of tax effects, some track the amortization of these tax impacts and reclassify them into the tax-expense line. This causes pretax income, tax expense, and after tax income to have more normal relationships.

A related comment along those lines can be made with respect to fresh start. If under the old law, 818(c) reserves were held and PGAAP had a low reserve, there would be a tax liability laid on top of the PGAAP reserves to recognize future taxable income, which would not emerge on a book basis. If you believe that the tax attributes are inseparable from the underlying pretax values, as APB 16 suggests, a case could be built for not deleting those tax attributes with respect to the fresh start. As those tax attributes are amortized, they would not be offset by taxable income and corresponding taxes. Therefore, they would be producing additional income prospectively. In that situation, it may not be unreasonable to measure the remaining unamortized tax effects and, to the extent the new law triggered a change in the tax basis of those reserves, to release the corresponding PGAAP tax effects that previously were included as part of benefit reserves.

Conceptually, tax effecting the purchase balance sheet is a relatively straightforward process of comparing the tax basis of assets and liabilities with the book basis and recording the related tax effects. However, it gets a little more confusing in practice.

MR. TIMOTHY F. HARRIS: In dealing with fresh start and PGAAP tax accounting, Mr. Stein, you talked about releasing the excess amounts you had set up under the old tax law. It is released at one time?

MR. STEIN: It's not dissimilar from the release of the deferred tax liabilities which took place with fresh start. These tax attributes are established in a type of liability method of deferred tax accounting. That's not permitted for regular deferred tax accounting, but the nature of the tax attributes recorded in the PGAAP balance sheet is similar to a liability type method of deferred tax accounting. A case could be built that, as a result of fresh start, these amounts should be released, even through they are included theoretically in the basic reserve. As a practical matter, they are frequently identifiable separately, and the unamortized portion of those amounts can be identified. It makes some sense to release these amounts if you believe that it makes sense to release deferred taxes in the first place.

MR. HARRIS: This advice may vary with accounting firms. I believe our accounting firm had us ratio the amount that was amortized as it came back into income. We set up a ratio of the rate that we expect to the rate at which these amounts were set up. Then, as the amounts are amortized and come back into income, we will take the excess into income.

MR. TUCKER: I perceive that the majority of companies view the purchase accounting assuming there really isn't a buried deferred tax liability, thus letting that income emerge over a period of time as opposed to taking it down all in one year.

MR. STEIN: That is the theoretically correct approach because one is not supposed to view the tax effects as separate items. The tax effects are supposed to be incorporated into the liability. It results in the amortization of the liability with no offsetting tax expense. I am not suggesting it or advising it, but rather raising it as a possibility that some have looked at.

MR. BICKEL: If you did take the tax effects down in one year, there is an implication that, if the tax rate were to increase, you would have to put part of it back up.

MR. STEIN: To the extent that the 818(c) amounts, for example, generate large tax liabilities merged into the basis of the reserves, those tax attributes, prospectively, are going to be eliminated. It's not a rate question in this instance. There's not going to be any tax on the release of those reserves. The reserves are not there anymore for tax purposes. I am not talking about changing the amounts to reflect a different rate.

Deferred tax accounting generally causes you to put up the amounts at a specified rate, and they are taken down as the timing difference amortizes, regardless of what the rate levels are. So I'm not talking about trying to modify the balance to recognize a change in rate but about how to deal with what was a tax reserve item and which no longer is a tax reserve item. Under the old law, it would have generated taxable income which now has been completely forgiven.

MR. HARRIS: You would adjust it for any amount of fresh start that is within that liability?

MR. STEIN: A case can be made for releasing the portion that has been forgiven, since it is similar to what was done with the deferred tax liability generally. In both cases, we have liabilities established for items which have been forgiven under the new tax law. I agree with Mr. Tucker on the inseparability of the amount. I'm just suggesting that it would not be unreasonable to take a look at that and to separately deal with that excess.

Mr. Bickel, is it fair to ask what you did?

MR. BICKEL: I did the same thing that Mr. Harris did. The new law reduced the tax reserve and also changed the tax rate. From a balance sheet point of view, you ought to adjust the liability to reflect both changes. However, to be consistent with the accounting system that we have, we lock in the liability based on the old tax reserve and the old tax rate, and let the liability roll off on that basis.

MR. STEIN: So you didn't change it at all. You're just continuing the same procedure.

MR. BICKEL: The liability is rolling off just like it would have under the old law.

MR. MAHAN: At Peat, Marwick and Mitchell, our position has been that you can't alter that lock-in of the tax adjustments due to subsequent events, unless it is an extraordinary event. Our position is that tax law changes are not extraordinary events.

MR. STEIN: Because of the similarity of the deferred tax accounting with respect to fresh start and this item, if you want to build a position that you can separately identify it, logic would call for comparable treatment. However, I think a strict reading of the rules would result in exactly what Mr. Mahon did.

MR. TUCKER: It certainly makes a lot of sense to release that amount immediately if you're getting ready to sell the company at two times book.

MR. BRUCE N. NELSON: Mr. Stein, you made a comment that under the step-up situation, some companies discount the asset. The tax assets have already been discounted in the sense that they are the present value of profits. What's the logic in double discounting?

MR. STEIN: If, in the step-up situation, the net GAAP reserve (meaning benefit reserve less the PGAAP insurance in force) is compared with the tax reserve, then the tax benefits of the tax value deductions must be handled. If you have a $100 million for tax value of insurance in force, over the future you will deduct $100 million on a tax basis, and that deduction will occur over time. As a result, the related tax effects will occur over time. Prospectively, you're going to get $100 million worth of deductions, and that amount is going to come out over a number of future years. Thus, the related tax attributes could be discounted.

MR. NELSON: Your pretax profits have been discounted, and they appeared to occur over the lifetime of the business.

MR. STEIN: Well, I don't think we're doing it twice. Start with a number for tax purposes. If you look at all the deductions that you put through your next twenty years of tax returns, the sum of those deductions is going to equal that opening balance, and those deductions are going to come out over the future life of the business. So, regardless of how you got the balance, the amortization of that absolute dollar amount will be over time, over a future period of years.

MR. BICKEL: The tax amortization periods and the GAAP amortization periods are not the same. As Bob said, the value of the insurance-in-force calculation for tax purposes is different from the calculation for GAAP purposes. The GAAP value is the value of a portion of gross premiums or discounted GAAP profits, while the tax value of contracts is typically the discounted tax profits. The tax value will be amortized over the average lifetime of the policies in force, following the holding of the Southwestern case many years ago. Rather than being amortized over the life of the business, it's only amortized over ten or fifteen years.

When a step-up in basis is elected, a couple of things will happen. A phase III tax is triggered, and amortization deductions are produced over ten or fifteen years. These taxes have cash impacts which affect the investment income of the company. By discounting the value of those deductions at the assumed after-tax investment-income rate, you will level out the effect of the change in investment income. The combination of change of real investment income plus the amortization of the discounted deductions will improve the matching of revenue and costs.

MR. NELSON: Assigning an estimate also takes into account new business writings which would affect taxes, i.e., the deduction because of drain on surplus related to new business writing.

MR. TUCKER: Say you're amortizing $100 million over ten years. The tax savings on that $10 million a year amortization is usually based on what the company thinks its effective tax rate will be on the tax return in each of those years, which will take into account the impact of new business. So you wouldn't take $100 million times 46 percent and show that as your asset; it might be 35 percent or some lesser rate.

MR. BICKEL: Another point of view is that the deductions should be discounted at a risk rate of return, which would produce about twice as much discount. The theory there is that the company may not get the deduction. The more you discount the deduction, the higher your earnings are initially and the lower later on.

MR. STEIN: Much later though, because the effect of the discount goes into goodwill.

MR. NELSON: Mr. Stein, could you bring us up to date on what the purchase accounting task force is discussing? After three years of reflection, what are the current issues?

MR. STEIN: As of our last meeting, we have agreed upon the life purchase accounting issues, with respect to the asset valuation questions, and most liability (including reserve valuation) questions. The only real outstanding issue is whether or not the value of insurance in force for book purposes should be developed and amortized using a risk rate of return or a net investment earnings rate. The impact of those variations is that use of the net-investment earnings rate would generally have earnings emerge as a percentage of premium, and that would follow regular GAAP for new business. Using the risk rate would have profits on the purchase block emerge as a return on investment, where the investment was measured by the present value of future profits. These two options are being debated, and I think we are leaning towards the net investment earnings rate, to maintain consistency with stock GAAP for new business.

This return-on-investment concept had been explored as a possible GAAP method when the audit guide was developed and was rejected at that point. Thus, I think the task force was a little unsure of its ability to permit a return-on-investment accounting model for an acquisition, when it was not being done on new business. There isn't any fundamental difference between buying a block of business by acquisition or through the payment of a commission to an agent.

The task force is beginning to talk about casualty issues, and we have begun to talk a little bit about the tax issues, but we have not made much progress.

MR. TUCKER: Well, the real world situation concerning tax issues is that everything we have talked about may be moot. Since 338 replaced 334(b)(2) and American General filed their ruling request on the acquisition of NLT Corporation (National Life and Accident) the IRS has been reviewing the application of 338 and 334(b)(2) to life and property and casualty insurers. Over the ensuing years, the IRS has discussed a number of theories as to how these sections should work for an insurance company. It has had many meetings with a group of ten people who have been "representing" fifty insurance companies. Reams of paper have been filed with the IRS, and it has yet to set forth a position in writing as to how it wants to see 338 and 334(b)(2) handled for insurance companies.

Several weeks ago, the IRS enunciated its position verbally again by contacting a number of insurers who had rulings on file with the IRS regarding acquisitions of insurers. Essentially, there are three parts to their communication to these companies. First, the IRS is going to apply what it has called a "statutory" theory to acquisitions of insurers when a 338 election has been made or 334(b)(2) is applicable. Under the "statutory" theory, the acquired company would recognize as ordinary income the full value of the insurance contracts that were acquired as of the purchase date. That amount would not exceed the amount of the insurance reserves. If one did a 334(b)(2) or a 338 acquisition, and the value of the insurance contracts were $100 million the acquiring company would get to amortize the $100 million over ten years, but a tax would be paid in the acquired company equal to 46 percent of $100 million all in one year. The "statutory" argument is that this type of acquisition is nothing more than an assumption-reinsurance agreement. The IRS said that this position will be made public in the form of several revenue rulings dealing with life companies, property/casualty companies, and presumably 338, 337, and 334(b)(2).

Second, the IRS said that the revenue ruling would make this statutory theory or argument only applicable to acquisitions occurring after August 1, 1983. That date is when the IRS put out a revenue procedure, saying it was not going to issue any more rulings on the acquisitions of insurance companies under 334(b)(2) until it had reviewed the area. Any acquisition that occurred prior to that date will be grandfathered from the new position under 7805(b). Anybody who acquired an insurance company after that date might be grandfathered on a case-by-case basis.

Third, the IRS doesn't know how to treat policy acquisition costs. It is not sure whether those underwriting expenses should be recaptured at the time of the 334(b)(2) liquidation or the 338 election. It wants to study this further. Depending upon the results of its study, the IRS may grandfather policy acquisition costs, or it may make an issue out of them.

Some immediate thoughts come to mind with respect to the IRS's oral communications to these companies. One is that its position is wrong. There isn't any substantive technical support or precedent for its position. My personal belief is that its position stems from a desire to hinder the ability of insurance companies to do tax planning.

Another thought is that the grandfathering date the IRS selected is entirely inappropriate. That revenue procedure that it is relying on didn't put anybody on notice with respect to the gravity of the position the IRS was ultimately going to come out with.

The third immediate thought is that there is no reason to save the policy acquisition expense position for further deliberation. Really, the

IRS's statutory argument in theory encompasses that, and it should be grandfathered also.

The "group" representing the industry has a number of planned responses to this IRS position. Right now it's difficult to fight the issue on the basis of the merits because we still don't have anything in writing from the government. We are shooting at a moving target, and every time we go to fight the issue with the IRS, we provide it with ammunition to further backstop its position. The position of the group is to not do anything on the merits of the issue until we see the IRS's position.

What was done immediately was to send a letter to Mr. Charles Morgan, the IRS Assistant Chief Counsel-Technical. The problems with the August 1, 1983, grandfathering date were pointed out. That letter was sent out about May 9, 1985, and pointed out to Mr. Morgan that, to the group's knowledge, there were at least ten acquisitions of insurers that occurred after August 1, 1983. These acquisitions were based upon the availability of 338 election, both in terms of pricing the acquisition by the acquiring company and also by the shareholders in figuring out how much tax they would have to pay on the acquisition. Additionally, there are a number of other insurance companies that are probably unaware of this oral communication of policy change that the IRS has made to a number of companies that filed private rulings. The letter also pointed out that there is no precedent for taking a revenue procedure date as the grandfathering date for a Section 7805(b) grandfather provision; that's just not an appropriate cut-off date. Furthermore, that revenue procedure did not give fair notice to anybody as to what the IRS's ultimate position was going to be. Revenue procedure 8357 did not mention property and casualty companies. It only dealt with life companies. It did not mention any "statutory" theory or argument. It did not mention the possible application of assumption reinsurance rules to a subchapter C reorganization. There wasn't any mention of any tax benefit theory. In short, no one was given fair notice of the IRS's ultimate position; the effective date it selected should be changed.

The other portion of the letter provided the IRS with a sample technical information release, which the industry believes the IRS should issue announcing its position and using, as the grandfathering date, the date of that issuance or release of the technical information release. In this way, everybody would be dealing with it fairly. Additionally, the letter pointed out that there isn't any reason for excluding the policy acquisition expense issue. That issue also ought to be considered and grandfathered in a technical information release just like the issue raised by the statutory theory. As of this time, we have indications that the IRS has received our letter and has read it, that it is under consideration, and that there is no need for the industry or this group to provide the IRS with any further information.

I am cautiously optimistic that the grandfathering date of August 1, 1983, will be moved to a more realistic date in 1985. There are three ways of fighting the issue, and all three are difficult.

One is to continue the administrative route by pressing the Treasury and the IRS to change their position. Since over a two to three year period we haven't convinced them, they probably aren't ever going to see the light.

There is the possibility of going to Secretary Baker and asking him to review the situation. If you do that, you run the risk of possibly giving up this grandfathering date, which has protected a number of companies who are at risk on the issue. I doubt if anything else will be done at the administrative level until the IRS's position is reduced to writing.

Another avenue of attack is litigation. The industry could attack the issue on the merits. That is, some company who made an acquisition subsequent to August 1, 1983, would go ahead and make the 338 election. When the government comes in and assesses the company a tax liability for the value of its insurance in force, the company would then go to the courthouse. It doesn't matter how much the experts believe that you have a 95 percent chance of winning in court; that 5 percent chance of losing is fairly high when you're betting the company on the amount of tax liability you would give up. Litigating on the basis of the merits is not realistic. You could come with a test case where somebody acquires a small insurer, makes a 338 election, asks the IRS to expeditiously audit the company and then goes to court. There would be a small amount of tax at issue and perhaps the industry would underwrite the loss of that. Other than something like that, there isn't any good way to litigate on the merits.

Another way is to seek a declaratory judgment or seek to enjoin the government from enforcing its revenue ruling. Based on conversations I have had with some attorneys, that is an approach which is highly unlikely to meet with success.

The third avenue of attack is to look toward legislation. That is possible, but this is probably not a good time to do it. It's something that the industry may want to seek a year or so from now. In the meantime, we have companies looking at 338 types of acquisitions who are still at risk, and there isn't any satisfactory solution immediately at hand.

What's the impact on the industry in terms of acquisitions on a going-forward basis? If I were planning an acquisition, I would forget about 338. I would price the acquisition and structure it on an advantageous basis to me without the benefits of a 338 election. There is little doubt in my mind that, as a result of the IRS's position, there is going to be a decline in taxable acquisitions of insurers. Taxable acquisitions are those that involve cash, notes, or something other than stock. This will happen because there will be a tax at the shareholder level without any offsetting benefit at the acquired-company level. There is some benefit in that the interest on the indebtedness to make the acquisition would be deductible. It would be hard to get the benefit of any loss carryforwards in the acquired company because of separate return limitation year problems of consolidated returns. There are also some of the provisions that the IRS has put into place to stop acquisitions of companies where one of the motivating factors is to acquire losses.

Acquisitions of insurance companies using stock, i.e., tax-free acquisitions, are going to increase. In that situation, there is no tax at the shareholder level, and the corporate attributes of the acquired company carry over. There isn't any doubt about the availability of loss carryforwards, earnings and profits, or whatever else.

All else being equal, there is a likelihood that the IRS's position will result in a decline in the price that would otherwise be paid for an insurance company. The operation of 338 and 334(b)(2) in the majority of situations produced a large benefit. Consequently, you may see some decline in the prices that will be paid for insurance companies.

Another reason you will see more equity acquisitions of insurers tax free is that the Treasury's initial proposals provided for the deductibility of dividends on common stock up to 50 percent. If stock is used to make an acquisition and a portion of the dividend is deductible, that type of acquisition vehicle becomes very attractive. It's still up in the air as to what the government's position will be when Treasury II is released.

One of the interesting things that will come out of this will be that those companies acquired through a 334(b)(2) or a 338 transaction will probably sell at a premium over those that have not, the reason being that the unamortized amount of the value of insurance in force will be available for deduction by the company doing the acquiring. Those companies will sell at a premium over a similarly situated company that had not previously been through a 338 or 334(b)(2) acquisition.

MR. BICKEL: The theory behind the IRS's position rests on two arguments. First, in the case of life companies, the IRS refers to Regulation 817 which defines tax accounting for assumption reinsurance cases. In the case of casualty companies, the IRS points to a case that was decided around 1970 called the Buckeye Union Casualty Case.

The argument about the reinsurance regulation is that any merger or liquidation of a life insurance company technically results in a reinsurance assumption, because some new entity has assumed the responsibility for that business. Since there is technically a reinsurance assumption, the IRS applies the regulation that has to do with reinsurance. That regulation says that when a company sells business and receives income for the value of the contracts, the value is classified as a negative reserve increase deduction rather than a positive income item in other income. This treatment has "deep significance." It implies that the income does not result from the sale of the contracts, but rather it results from the release of redundant reserves. If the gain does not result from selling the contracts, it is not exempt from taxation in a corporate liquidation.

The regulation was written back in 1960 or so, and the people who wrote that regulation say that's not what was meant at all. The reason they classified the value as a negative deduction was that they didn't want anybody to claim that it might be capital gain income rather than ordinary income. They thought the negative deduction treatment would strengthen their case. There is even language in the Congressional history of the 1959 Act that says Congress did not intend anything in the 1959 Act to override the rules about mergers and liquidations, except where the merger rules were specifically referred to, as they were in connection with the Phase III tax. The regulation has been around for twenty-five years, and no one thought of this interpretation until now.

In the case of the casualty companies, the IRS refers to one case where a casualty company adopted a plan of liquidation under Section 337. Under a 337 plan, the company has a year to sell all of its assets and distribute the money to the shareholders. Section 337 says that, if you do this within a year, there is no tax on the sale of your assets. To sell the insurance contracts, they negotiated a reinsurance assumption contract. The Tax Court, affirmed by a circuit court, said that the reinsurance assumption contract was not a sale of the policies. The courts were confused between indemnity reinsurance and assumption reinsurance. Thus, the gain was not a gain from the sale of the property and was not protected from tax by Section 337.

A year later the same Tax Court held that assumption reinsurance is a sale of contracts, and they have held so ever since. Every other precedent since that time recognizes that assumption reinsurance is a sale. Even the conference report in the 1984 Act says that assumption reinsurance is a sale of property. The IRS and the Treasury realize this, but they don't like what happens on the buyer's side -- the big reduction in corporate tax after the sale of the company. By taking this position with respect to the selling company, and grandfathering the past transactions, they can shut off future deals. They feel they have plugged a loophole.

The logic of the grandfather date relates to a Revenue Procedure issued in August 1983, which said the IRS was going to study two or three issues relating to life insurance company liquidations. At that time, no one in the IRS had dreamed up the statutory theory. The IRS theory was developed around January of 1984. No one could have known in August 1983 that the IRS might take this position. The IRS probably should have put out some kind of public announcement last spring.

Their thinking on the acquisition expense issue is that, under the statutory theory, there will be a tax on the value of insurance contracts, to the extent that the value does not exceed the reserves. That is the amount in the regulation that is netted against the deduction. If the value of insurance contracts is more than the reserves, then the excess is reported as other income -- a positive item -- and is protected from taxation by subchapter C. This situation won't happen too often, but it will happen in some cases. In cases where it does happen, the IRS wonders why the value of insurance contracts is greater than the reserves. It suspects that maybe it's because the company got too many deductions in the past for its acquisition expenses.

The IRS intends to look at that issue. It may decide to rule positively. We know that there are other factors that impact the value of insurance in force, such as profit margins, changes in interest rates, and so on, but the IRS has not focused on them.

The IRS says it is working on revenue rulings. There could be several of them. We might expect one for life and one for casualty, and perhaps one for 338 and one for 334(b)(2). These rulings will not address the acquisition expense issue, but they will address the reserve issue. At one time, the IRS thought it might publish the rulings as early as June 1985. It is basically agreed on what to say and is anxious to get the rulings out in June, since many companies have to make 338 elections in August.

The present status is that we are waiting to hear a response to our request to change the grandfather date and to clarify the acquisition expense issue.

MR. MILLER: What do we do if we don't get anything definitive by August? Do we file or not?

MR. TUCKER: If you have an acquisition after August 1, 1983?

MR. MILLER: Yes.

MR. TUCKER: I would be hard-pressed to make that election. Your only alternative is to try to go in and get an extension of the time for you to elect. There are some procedures for doing that. It would clearly be a hardship case.

MR. BICKEL: If we don't hear quickly, companies in that position should make individual requests for 7805(b) relief. They have a fair chance of getting it. The argument would be that the purchase price negotiations were made on a basis that did not contemplate this kind of tax. Surveys we have made suggest that in eight or nine cases out of ten the amount of the tax would drive the company into insolvency.

MR. TUCKER: If the IRS doesn't put out any ruling, wouldn't everybody have to go for 7805(b) relief, because there isn't any published announcement on the grandfathering?

MR. BICKEL: That could be. What do you recommend for the companies that did an acquisition before August of 1983?

MR. TUCKER: I think they would have to go in individually also and ask for 7805(b) relief because there wasn't anything in writing saying that they were grandfathered.

MR. BICKEL: Some of the advisers are saying to go ahead and elect even if the IRS does nothing before then, based on the conversations.

MR. TUCKER: Regardless of the consequences?

MR. BICKEL: Yes. That would be our probable action.

MR. TUCKER: You would go to the courthouse?

MR. BICKEL: Perhaps, or to Congress.

MR. TUCKER: You feel they won't do something that's going to render every insurance company that was in an acquisition insolvent?

MR. BICKEL: Yes. Our real mistake was in asking for the ruling in the first place. One thing that I have learned from this is that, when you have a big issue, you should act on opinion rather than request a ruling.

MR. TUCKER: You didn't know you had a big issue.

MR. ALBERT K. CHRISTIANS: We are contemplating the sale of a block that has one of these transactions from 1982 associated with it. If we sell that block for cash, presumably we get to offset the attributed gain from the sale against the unamortized cost which we had previously set up, so we wouldn't pay a tax liability in the selling company. Is that right?

MR. BICKEL: You're selling the block of business?

MR. CHRISTIANS: We're probably selling the block of business.

MR. BICKEL: Your basis in that block of business is affected by the deductions you have been taking.

MR. TUCKER: You would be able to offset if it's a reinsurance assumption. Is it?

MR. CHRISTIANS: Probably.

MR. TUCKER: If you do it with indemnity reinsurance, you've got a problem.

MR. CHRISTIANS: It would not be indemnity reinsurance. It would be either an assumption of purchase of the company.

MR. TUCKER: If it's the purchase of a company, there isn't any write-off, because the basis is within the company against a certain asset.

MR. CHRISTIANS: On these acquisitions for stock, is there any way you can mix cash and stock? What are the limits of what can be done in a tax-free acquisition?

MR. TUCKER: There are several types of tax-free acquisition statutes. Generally, in a merger or a 368(a)(1)(A) acquisition, you can use any type of stock, voting or preferred, and you can mix consideration other than stock in the acquisition, provided that the stock is at least 50 percent of the total consideration. That's the IRS's ruling policy. You can mix other types of consideration in some types of acquisitions, for instance, when you swap stock for 80 percent of a company. In that situation, if it's a stock swap you have to have all voting stock and have to acquire at least 80 percent of the company for voting stock in order to be tax free. It depends upon how you are trying to qualify.

MR. STEIN: In regard to accounting for joint ventures and equity accounting, we are talking about minority positions in companies and partnership interests. Equity-accounting rules apply.

In a minority-interest ownership case, equity accounting would be the rule to follow, and the owner of the minority interest would bring into its income its equity in the earnings of the minority-held organization. In an acquisition situation, if there is an initial minority purchase, there have been instances where the acquiring company has gained substantial control even though that company had a minority interest. While technically this is an equity-accounting situation, the control aspects may result in using PGAAP for the minority acquisition. The buyer would record its interest in the purchase-adjusted earnings of the minority company.

In come of these cases, the acquiring company has gone on to acquire the remainder of the company. In such instances, depending on the changes in market rates of interest, subsequent transactions may also have to use PGAAP. This "step-purchase" accounting requires fair market valuations of the acquired company at different points in time, reflecting the ownership interest increases at those dates. I don't think this is common, and it certainly is a practical problem to be avoided if possible, but it has taken place. In most cases, however, minority acquisitions would follow the equity-accounting rules.

Partnership involvement is similar. Equity accounting, in general, would apply. If the acquiring company has partnership interests, there is a theoretical need to revalue that ownership interest in the partnership. As a practical matter, that's probably not done often, but there would certainly be an argument for revaluing your share in the partnership.

MR. BICKEL: Joint ventures are a broad category. One problem with certain types of limited partnerships is that it is difficult to get the necessary data. The reports may come in unaudited, or they may be audited and qualified. If they were material, we would have a problem.

MR. STEIN: That's the case with many of the minority and partnership situations. While in theory, there should be a revaluation, the inability to assess the value of the assets and liabilities of an oil and gas partnership or a real estate development partnership more often than not results in the continuation of the equity accounting of the purchased organization. Unless the buyer has been able to take control of the organization, the organization may not give the buyer the information to do a fair market valuation of the minority interest in the acquired company. Thus, the buyer probably will need to continue the equity accounting on a historical basis.

MR. BICKEL: There are joint ventures involving minority interests of a corporation, joint ventures involving limited partnerships, and joint ventures involving reinsurance transactions, where you agree to divide the profits through reinsurance. There are joint ventures where the parties agree to share the profits based on internal company allocations. I can see the numbers getting buried and problems developing that way.

MR. STEIN: In effect, all of those relationships, while possibly not formal partnerships are, in substance, partnership arrangements. Also, they may contain special provisions for the sharing of gains and losses among the partners. Again, I would expect that the unavailability of data would be a real problem and that revaluations of these kinds of transactions would be relatively rare.