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ACTUARIAL ASPECTS OF A PURCHASE TRANSACTION

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In addition to the preparation of an independent appraisal, there are other actuarial issues that arise in a purchase transaction. Panelists will discuss related issues, including GAAP reporting, statutory valuation, and taxation aspects of completing a sale.

MS. PATRICIA L. GUINN: Many of you, I am sure, are quite familiar with actuarial appraisals that are often done in mergers and acquisition situations. The purpose of this session is to go beyond the appraisal and talk about other things that the actuary needs to do when a company or a block of business is bought or sold. We have organized this session into three bits. We will look at company transactions from the side of statutory and GAAP accounting. We will look at tax aspects of company transactions. Then we will look at special considerations for blocks of business.

I would like to introduce the panel to you. I am with Tillinghast in New York. Jim Wallace is both an accountant and an actuary. He is the director of the insurance practice for the eastern U.S. at Ernst & Young. Dick Miller is a consulting actuary and is closely associated with Tillinghast. Bob Beuerlein, who is senior vice president and chief actuary of Franklin Life, will talk about the block transactions.

MR. JAMES D. WALLACE: I am going to cover rather quickly quite a bit of ground about the statutory and GAAP accounting for the acquisition of a life insurance company, as opposed to a block of business. I think the best way to do that is to hop right into an example.

Table 1 shows statutory balance sheets for a possible buyer, Company A, and a possible target, Company B. As you can see, Company A has $1 million in bonds, surplus of $200,000, and reserves of $800,000. The first thing would be to come up with a price for Company B. You need a price to do any accounting at all either on a statutory basis or on a GAAP basis.

TABLE 1
ACQUISITION OF ONE LIFE COMPANY BY ANOTHER
STATUTORY BALANCE SHEETS—BEFORE

	Company A (Buyer)	Company B (Target)
Asset		
Bonds	$1,000,000	$500,000
Total	$1,000,000	$500,000
Liabilities and Surplus		
Reserves	$ 800,000	$460,000
Surplus	200,000	40,000
Total	$1,000,000	$500,000

Table 2 shows a traditional actuarial appraisal. There are three components of value. After studying the appraisal, Company A determined that the value it would pay for Company B is $125,000, which happens to be the value discounted at 13% (with required capital). So the first step in doing accounting is knowing the purchase price.

Recording the acquisition on a statutory basis is the easier of the two calculations that one has to make. The other (GAAP) is considerably more difficult. A purchase of an insurance company has no impact whatsoever on the accounting for the acquired company. So Company B statutory accounting will continue unchanged once it has been acquired by Company A. But if Company A is an insurance company, it must deal with some accounting quirks. In particular, when Company A records Company B on Company A's books, a goodwill limitation consideration must be made. Company A can only record goodwill on the acquisition of Company B to the extent of 10% of Company A's surplus after the acquisition is made. That goodwill then must be amortized over ten years. The vast majority of the states allow goodwill as an admitted asset, subject to the aforementioned 10% limitation. There are some exceptions.

TABLE 2
COMPANY B
ACTUARIAL APPRAISAL VALUES

	11%	13%	15%
Adjusted Capital And Surplus	$ 45,000	$ 45,000	$ 45,000
Value of In-force Business			
No Required Capital	101,873	90,555	81,421
With Required Capital	87,216	73,674	62,895
Value of New Business			
No Required Capital	23,952	12,915	5,049
With Required Capital	17,268	6,100	(1,579)
Total Value			
No Required Capital	170,825	148,470	131,470
With Required Capital	149,484	124,774	106,316

Let us look at how goodwill is determined. You will recall that the purchase price for Company B was $125,000. You will recall that the surplus of Company B was $40,000. Well, to the extent the purchase price exceeded the surplus of the company being bought, we have goodwill. In our case, there is $85,000 of goodwill. Company A will only be able to record its investment in Company B to the extent of the statutory surplus of Company B plus goodwill equal to 10% of Company A's surplus. So, in this situation, Company A is only able to record the acquisition of $40,000 of surplus and then $12,000 of goodwill, and so Company A must take an immediate hit for $72,000. The following will help you see how we came up with that number.

Again, this is for statutory accounting purposes only. In Table 3 we are looking at Company A, the buyer, not the seller. Beforehand, Company A had $1 million of bonds, and the purchase price was $125,000. The assumption here is that Company A liquidated $125,000 in bonds and was able to liquidate those bonds at book value, and so the first adjustment to Company A's books is simply the purchase price. The assets had to come from somewhere. Then Company A will record Company B on Company A's books. It will be able to record it at the statutory surplus of $40,000, but then it is limited to recording its investment in terms of goodwill at 10% of Company A's surplus after the acquisition. As it turns out, after the acquisition there is only $127,000 of surplus. You have to go through an algebraic equation to come up with the number, but Company A can only record $52,778 of the $125,000 it paid. So Company A took an immediate write-off of surplus of $72,222. That is a significant consideration when one life company buys another.

TABLE 3
EFFECT OF PURCHASE OF COMPANY B
ON COMPANY A'S STATUTORY BALANCE SHEET

	Before	Adjustments	After
Assets			
Bonds	$1,000,000	$(125,000)	$875,000
Common Stock			
Statutory Surplus	--	40,000	40,000
Goodwill	--	12,778	12,778
Total	$1,000,000		$927,778
Liabilities and Surplus			
Reserves	$ 800,000		$800,000
Surplus	200,000	(72,222)	127,778
Total	$1,000,000		$927,778

There are a number of ways to account for Company B after the acquisition on a statutory basis. The most common method is simply for Company A to carry Company B at statutory equity plus goodwill, amortize the goodwill over ten years, and then record the increases in Company B's equity to unrealized gains on Company A's financial statement. There are other methods, but I think in the interest of time we will move on.

The more difficult, and maybe more interesting, calculations, though, are the GAAP calculations. So now we are going to look at a situation in which the acquiring company either is not an insurance company and, therefore, is not subject to statutory accounting, or is an insurance company, but we are dealing with GAAP financial statements instead of statutory financial statements. In situations such as that, the acquiring company does not get caught up in these goodwill limitation rules. The rules are completely different, although the acquiring company does remain subject to insurance holding company rules.

When an acquisition occurs of one company by another, the first thing you have to determine for GAAP purposes is whether you have a purchase or a pooling, and the accounting is profoundly different. One of the considerations in determining whether you have a purchase or a pooling is the basic theory. The theory of a purchase is the acquisition of assets of one company by another. It is actually a takeover. In the case of a pooling, you have the uniting of interest or two companies merging and coming together. Under a purchase, really anything can be used as the purchase price. You can use cash, stock, warrants; you can have contingent payments. Under a pooling, you can only use voting common stock. So if you are going to have a pooling, companies can only use voting common stock to acquire one another. I can tell you that it is very difficult to convince the SEC you have a pooling. It may happen, but it is rare. In a purchase, you can buy all or part of a company. In a pooling, you must get at least 90% or you do not have a pooling. You are stuck with a purchase.

The difference in accounting between a purchase and a pooling is that under a purchase, all the assets and liabilities of the acquired company will get marked to market value. Under a pooling, there will be no market value adjustments. All the values will carry over at the historical book values. Under a purchase, goodwill will arise, equal to the excess of the purchase price over the fair market value of the assets and liabilities acquired, and that will be amortized over not more than 40 years; typically, about 25 or 20 years. There will be no goodwill in a pooling. Under a purchase, the earnings of the acquired company will be reported only from the date of acquisition going forward. Under a pooling, you will add together the earnings and restate all prior periods in the financial statement.

Let us look at an example because I think it helps. Let us look at the acquisition of Company B. We are going to look at what the purchase GAAP adjustments would be to Company B as a consequence of an acquisition. The first thing we must do is mark all the invested assets to fair market value. The bonds and other invested assets will all be marked to fair market value. Policy loans typically carry over at book value. Some people try to market-value-adjust those but, as a practical matter, those carry over at book value.

Historical deferred acquisition costs are eliminated. They are wiped off the balance sheet. They no longer have any relevance, and they are replaced with the discounted profits, the value of the insurance in force. Policy reserves will be adjusted. You eliminate the old policy reserves, and for *Financial Accounting Standard (FAS) 97* business, replace them with full account balances. For *FAS 60* business, you revalue, and we will talk about that in a minute. Historical deferred taxes are eliminated, and deferred taxes are provided on all the temporary differences, which we will go through as well.

The most actuarial-intensive aspect of the acquisition would be the determination of the present value of future profits. That replaces the historical deferred acquisition cost (DAC) balance. The question is: how do you get the present value of future profits that gets put on the balance sheet? There really are a zillion different ways to do it. It could be the present value of statutory profits. It could be historical GAAP profits or purchase GAAP profits. It could be adjusted for the cost of the capital. It may not be. It could utilize scenario testing. It could be the amalgamation of a number of scenarios, or it could be a single interest rate scenario. This really is not codified. The bottom line is once you determine the present value of future profits, it really ought to be done in a manner that is consistent with the actual economics of the purchase price. We will go through that here as well.

Back to the acquisition then. Company B has been purchased for $125,000. Market rates are up and so the bonds are under water. There is an unrealized loss on the bonds. The transaction is a taxable purchase of stock, so there will not be any tax basis in the value of the insurance in force. All the business that Company B has is *FAS 97* business. We have determined that the present value of future profits is $170,000, the value of insurance in force. Those are our givens.

So the first calculation you make is the deferred tax calculation. That requires you to schedule out the tax basis of all the assets and liabilities against the purchase GAAP basis, the fair market value. So in our example (Table 4), bonds have a tax basis of $500,000. Because interest rates are up, the fair market value is only $465,000, and there is an unrealized loss of $35,000. The value of the insurance in force, because of the way we did the transaction, will have no tax basis but will have $170,000 on a book basis. Reserves have a tax basis of $460,000 and a book basis of $480,000, and all those differences are tabulated and multiplied by 35% in our case. So we will need a deferred tax liability of $40,250, which is just the tax rate times the difference in the book and tax basis.

TABLE 4
PURCHASE ACCOUNTING CALCULATION OF TAX PROVISION

	Tax Basis	Book Basis	Difference
Bonds	$500,000	$465,000	$(35,000)
Present Value of Profits (PVP)	0	170,000	170,000
Reserves	460,000	480,000	(20,000)
			115,000
			x 35%
			$ 40,250

We hope we can put it all together for you now (Table 5). We now need to post-purchase-GAAP (P-GAAP) adjustments to the historical-GAAP (H-GAAP) balance sheets to get a P-GAAP balance sheet. The bonds are marked down $35,000 to get the fair market value. The historical DAC is eliminated. It is simply zeroed out. It is replaced with the present value of profits (PVP), the present value of future profits of $170,000. Goodwill is absolutely a plug. It is the number that makes assets equal liabilities and equity. Under liabilities, you recall, we said all the business was *FAS 97*, so the reserves were full account balances on an historical GAAP basis. They are still full account balances on a purchase-GAAP basis, so there is no difference in our example between reserves. Then we calculated the deferred tax liability earlier of $40,250, and so an adjustment was made to force that value to equal the $40,250. Finally, equity must be the purchase price. Whatever you paid for the company must be the equity as a result of the transaction. So purchase-GAAP equity is $125,000, and goodwill is a plug.

Let me mention a couple things about the present value of profits (PVP). There used to be a number of ways to amortize the PVP. You could really control earnings, to a great extent, on an emerging basis, but Emerging Issues Tax Force (EITF) 92-9 changed all that. The short of it is that EITF 92-9 does not tell you how to get the PVP, but once you have it, you have to amortize it for *FAS 97* business over future gross margins, and you have to accrete PVP at the credited rate on the underlying contracts, not at the risk rate. For *FAS 60* products, the PVP must be amortized as a constant percentage of premium at the liability rate, the rate that is inherent in the reserves. *FAS 97* PVP can be unlocked for emerging experience just as you unlock DAC for universal life business, but not *FAS 60* except for current terminations. PVP must be tested periodically for recoverability.

TABLE 5
EFFECT OF PURCHASE ACCOUNTING
ON COMPANY B'S GAAP BALANCE SHEET

	H-GAAP	Adjustments	P-GAAP
Assets			
Bonds	$500,000	$(35,000)	$465,000
DAC	75,000	(75,000)	—
PVP	—	170,000	170,000
Goodwill	—	5,250	5,250
Other	5,000		5,000
Total	$580,000		$645,250
Liabilities and Equity			
Reserves	$480,000		$480,000
Deferred Taxes	19,250	21,000	40,250
Subtotal	499,250		520,250
Equity	80,750	44,250	125,000
Total	$580,000		$645,250

I want to conclude with *FAS 60* reserves because there is a lot of confusion about how to get adjusted *FAS 60* reserves. When you acquire a block of business that includes *FAS 60* reserves, traditional nonparticipating life insurance, you will need P-GAAP reserves. *FAS 97* is easy because *FAS 97* reserves are just account balances, but *FAS 60* is a little more difficult. To calculate the *FAS 60* reserves, you have to use updated current assumptions. You do provide a provision for adverse deviation, and there really are two different methods to calculate those reserves. The first is the defined initial reserve method, and the second is the defined valuation premium method.

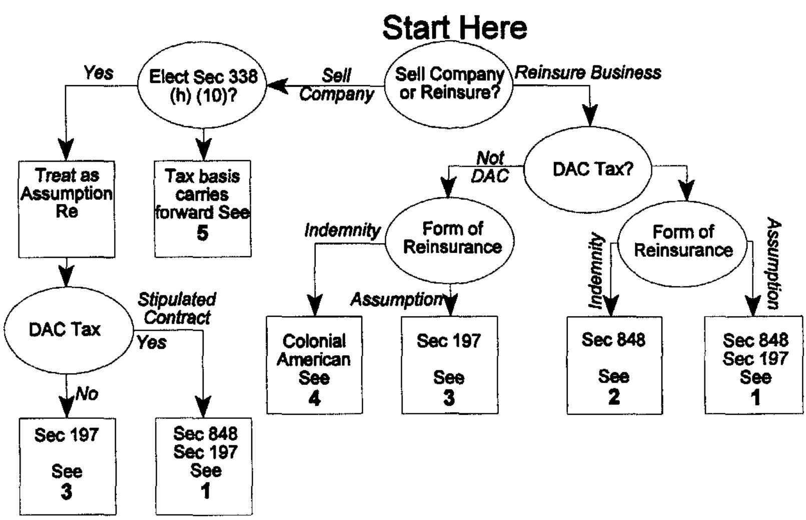
Let me briefly tell you how to get them. On the defined initial reserve method, and not everyone agrees on what exactly that means, but generally, the notion is that you will assign to your acquired reserves a value equal to what was determined in the purchase price. So generally what, in an appraisal, you will pay for statutory reserves is equal to the statutory reserves minus the present value of future profits, at a risk discount rate. So the defined initial reserve generally is meant to mean the statutory reserves minus the present value of future profits, on a pretax basis, of the acquired business. Now you cannot record statutory reserves for purchase GAAP. Most accountants will not let you. So it will be necessary then to adjust those statutory reserves to a GAAP basis and them solve for the discount rate of the present value of future GAAP profits so that your GAAP reserve minus your present value of future GAAP profits would be equal to the statutory reserve minus the present value of future profits.

The other way is the defined net valuation premium method, which I will define. This is a little more straightforward, and maybe it is based more on first principles that you all understand better. The reserves are equal to the present value of future benefits and expenses minus the present value of the future valuation premium where you derive the valuation premium by taking the gross premiums of the acquired block and backing off an amount for loading, which would be a profit margin commensurate with a similar business. Then reserves are figured prospectively thereafter. That reserve then needs to be split between deferred acquisition cost and benefit reserves, which is done by exploding the net valuation premium in a somewhat arbitrary fashion.

I appreciate that this was a lot to cover. I hope much of it was background for a number of you. We are moving on to taxes.

MR. RICHARD S. MILLER: We can talk about either the tax aspects of a company purchase or the tax aspects of a purchase of a block of business. Chart 1 is a decision tree, and it treats these decisions as you would typically go through them.

CHART 1
DECISION TREE



1 Capitalized net consideration (Income Item) = DAC. Amortize DAC over 11 years. Capitalize *excess* ceding commissions (Income Item) as Sec 197 asset. Amortize Sec 197 over 180 months. Ceding commission is deductible in first tax return, but at best offsets the Income Items.

2 Capitalize the net consideration (Income Item) = DAC. Amortize DAC over 11 years. Tax basis ceding commission is immediately deductible, but may be more or less than capitalized DAC.

3 Capitalize complete tax basis ceding commission as Section 197 Asset (Income Item). Amortize Sec 197 over 180 months. Ceding commissions deductions neutralize the capitalized Sec 197 and thus the net effect is the 180 months of deduction.

4 Capitalize tax basis ceding commission and amortize over useful lifetime (often 10 years). Deduction of ceding commission offsets the capitalization.

5 Existing DAC in "seller" carries forward to buyer. Tax basis of assets also survives.

Note: Negative ceding commission in 1, 2, 3, and 4 becomes current income subject to tax. There is no negative Sec 197 asset or Colonial American asset.

Almost all the tax aspects of a purchase transaction, and we are using the broad definition of purchase transaction, will initially be determined by the seller. Often the seller has some choices to make in this area.

The decisions on the tax circumstance often center around the company's intentions with respect to the block of business and/or the company. Nonfinancial income or balance sheet result decisions will often affect powerfully the decision of whether to sell or reinsure, which is the first consideration. Once you get beyond the nonfinancial considerations of exiting a line of business or getting rid of a company, the actuary can then contribute significantly in making the decisions on which basis for structuring the transaction will be most profitable. Taxes definitely enter into that consideration. From earlier work, the typical appraisal comes up with a present value of future profits (PVFP) on a block of business. That calculation is normally before taxes. The circumstance of the transaction must then be determined before the total tax effect can be determined.

The decision tree helps to determine what tax rules will apply if you decide to reinsure, rather than sell, the business. I have positioned the determination of what the DAC affects first in this decision tree because that is something that generally is not subject to the company's own decision; it is just a fact of the circumstances. IF the business is subject to DAC, then you can decide which form of reinsurance to go into. If it is DAC-able, the form of reinsurance could be an assumption, in which case there is a blend of tax rules.

We have to look at Section 848, the DAC rules, and also at Section 197, the new capital transactions capitalized cost rules. Regulations are coming out on how Section 197 is to integrate with Section 338(h)(10), in particular with life insurance. Those rules will be interesting. There is an inherent conflict between the tax code subchapter C (the general corporate tax code on capital transactions) and the way Congress has put together transactions that are basically capital transactions under subchapter L, the life insurance tax code.

If the form of reinsurance is chosen to be indemnity, that is a different situation. The company is strictly under Section 848, and the determinations are much cleaner and much easier. If the business is not business that is subject to DAC, again, you still have a choice of tax situations between whether you choose indemnity or assumption. If you are not subject to the DAC treatment and you choose assumption reinsurance, the business is exclusively under Section 197. This basically says that whatever the ceding commission is, using tax reserve to determine the ceding commission, the ceding commission is an amortizable asset generated by the purchase transaction. That asset is amortized over 180 months. That is a clear determination now. It also means that for tax purposes we no longer need a tax appraisal, which is good for companies in their transaction. They have more certainty. It is bad for consulting actuaries, but on balance, I think, it is still a good thing for the country.

Assumption reinsurance is not all that popular anymore. Companies wanting to get rid of a block of business are very leery of assumption reinsurance because they have suddenly realized that they still have a contingent liability of some fair substance even though they may call the contract assumption reinsurance. And so indemnity reinsurance with or without the trusteeing of assets and all this type of thing may be the chosen route. In that case, the Colonial American decision applies.

But you have to capitalize something, and the capitalization is that ceding commission, the tax basis ceding commission, and it is amortizable as well, usually over ten years. The actuarial question is: what is the appropriate lifetime of the business? Ten years is often used because it is the example that was given by the IRS in the 1972 regulatory rulings and has generally been accepted by the IRS. Shorter amortization periods are obtainable on a very quick turnover business. Some individual health insurance is the classic example. Longer amortization periods theoretically should apply on some types of business. To my knowledge, the IRS has never been successful enforcing longer periods, but some companies have voluntarily gone to longer periods.

If the decision is made to sell the company, then we still have two decisions, or two routes, to go. One is whether to sell the company as a company; that is, sell the stock of the company, or sell the company as a sale of assets under Section 338(h)(10). If the sale is made as a company, then to the selling company the tax consideration is what the purchase price is versus the tax basis in the stock of the company. That tax basis in the stock of the company is often referred to as the outside basis. In my own opinion, that is a question that really can only be answered by the people who literally put together the tax return. Even those people will often have to go back and do research for many years to arrive at a number they think is their outside basis in the stock. It gets very complicated. It is involved with the part of the tax code called earnings and profits (E&P).

The other side of the decision tree is to go through a Section 338(h)(10). The write-up of the conference committee, in instructions to the Treasury about Section 197, very specifically gives reference to treating 338(h)(10) as some form of assumption reinsurance. It is not part of the law. The assumption is that the emerging regulations will indeed confirm that basis. Most practitioners, I think, are advising clients that, yes, it will be treated somehow as assumption reinsurance. Now we must decide what that means.

If we come down to the decision again on whether it is a DAC block of business, we can then branch off to the same two conclusions that we saw on the other side. If it is an assumption reinsurance transaction and it is DAC-able, we have Section 848 and Section 197 to consider. Or if it is not DAC-able, we just have Section 197, which is absolutely the cleanest of the situations. If you decide to not go through the Section 338(h)(10) election, then the sale of the company is just the sale of the stock. The tax basis in all the assets and liabilities of the company remain the same. That carries forward, and then you just have a normal continuing situation.

One other comment needs to be made in particular with respect to this decision tree. That is that negative ceding commissions (the situation in which the purchase assets or net consideration going across are less than the tax reserves) cause all sorts of nasty questions. And that is probably the one least settled area. We have seen many recent instances where negative ceding commissions are involved. Long-term care is a typical situation in which the tax reserves are so low that they actually generate either negative tax basis ceding commissions, or ceding commissions that are substantially less than the DAC-able amount, which also brings up almost the same question of a negative ceding commission.

Structured settlements are another area where this is often the case. In today's marketplace, business that was written back in the early 1980s will be carrying tax reserves that are dramatically insufficient to handle the business if assets are at market value in today's market. Of course, in all these transactions except the sale of the company stock, the invested assets come into the acquirer's tax books at market value. So negative ceding commissions are not an unthinkable thing. They are an extremely complicating item.

That sets the stage, I think, for Bob to go strictly into the block transaction, and I will turn it over to him.

MR. ROBERT M. BEUERLEIN: As Dick said, I will talk about blocks of business. How many folks have been involved in a purchase of a block of business or in the sale of a block of business in your career? For some reason, that does not surprise me because a lot of action is going on in the block arena.

Why is it that companies get into either acquiring blocks of business or selling blocks of business? Well, there are probably many reasons. It might be getting more focus on what they are doing. Maybe they do not have the critical mass so they are getting out of the block of business. Or they do not have a critical mass so they are trying to acquire more to get that critical mass. Maybe they are not profitable in a block of business and they just want to get out of it. But whatever the reason is, a lot of action is going on out there, as I am sure you are all aware. You also find out, in my opinion, that many prices out there are probably not the ones they should be. Many companies have a strategy of growing through acquisitions, and the prices are fairly high. Many blocks of business do not even have actuarial appraisals associated with them. Without actuarial appraisals, the price can just fluctuate every which way. I guess the long and short of it is that many things are going on, and it looks probably like about 75% of the people raised their hands.

Dick talked about assumption reinsurance and coinsurance. Three or four years ago, assumption reinsurance was probably the favorite way to go. People thought that was probably fairly safe to do. Things have changed a lot during the last few years, and we are seeing that coinsurance is probably the more popular way of doing things.

You can accomplish the same things through a 100% coinsurance arrangement as through an assumption reinsurance arrangement. If you go through a 100% coinsurance, you do not have to deal with some of the regulations regarding approval of the policyholder. We see hybrids where an assumption reinsurance contract has coinsurance on the side for certain policies that do not elect to take the assumption reinsurance. That is not really the point of what I am talking about here, but we have to consider that because the accounting for assumption reinsurance and the accounting for this 100% coinsurance are two different things.

Let us start with statutory accounting. Really, statutory accounting in a purchase block of business is easy. Typically, because a block of in-force business has value, the sale transaction will result in a gain for the ceding company. If the policies are somewhat mature and have reasonably large reserves, the transaction will result in a transfer of cash or other assets by the ceding company. In this case, the reserves released by the ceding company will be greater than the value of the assets transferred, with the resulting credit being an increase in surplus for the ceding company. If the policies are young and have some small reserves, the assuming company may pay some amount in the purchase.

We want to also think about surplus relief transactions, or other types of reinsurance. These will be handled somewhat differently. If the ceding company has an obligation to buy back the block of business, or to repay the reinsurer's losses, the intent of the transaction has usually been to create surplus in the ceding company. Such an intent is not consistent with statutory accounting practices. Here the accounting for the transaction must look beyond the intent and record the obligation. Therefore, there is no gain or surplus increase to be recognized, but the credit would be recorded as a liability to reflect the obligation to repay the difference to the assuming company.

Let us assume that we are not dealing with surplus relief. We are doing a purchase transaction. For both reinsurance transactions, the ceding company will transfer assets to the assuming company to accompany the policy reserves. From the standpoint of the ceding company, the gain or loss is the difference between the amount of reserves released and the carrying value of the assets transferred. For assumption reinsurance, we get to use a little bit of what Jim was talking about. The assuming company must record the transaction for statutory purposes by following the same principles used in the acquisition of a subsidiary. The assets acquired must be valued at their respective market values, and the reserves must be established in accordance with the provisions of the policies. The difference between the asset and liability amounts forms a goodwill that must be amortized over a period of not more than ten years. So for statutory purposes, with assumption reinsurance, there is goodwill, and with coinsurance, you do not set up goodwill.

We have also some interest maintenance reserve (IMR) considerations. The interest-related gain or loss associated with a sale, transfer, or reinsurance of a block of liabilities must be credited or charged to the IMR and then amortized into income, assuming that the following three things exist:

1. The portion of the block reinsured represents more than 5% of the company's general account liabilities;
2. The transaction is irrevocable; and
3. The transaction was completed in the current year.

Let us get to purchase accounting. Many purchase GAAP principles apply to what we were talking about in the sale of a company. Now let us think about it in a bit more practical term. Many times when we are dealing with blocks of business in a purchase situation, it might not be a large amount for the company, so a company might not want to spend many resources. You can develop some shortcuts in doing your purchase GAAP accounting. Remember, the theory behind purchase GAAP is to mark liabilities and assets to market at the time of purchase. You are really looking for the net purchase GAAP liability, both initially and going forward.

If it is not a significant transaction, many companies may be able to get away with using statutory reserves as a liability, setting up the purchase price as the asset and then just accounting in the future with the statutory reserves as the liability and amortizing the purchase price. This is a shortcut that the accountants usually do not like if it is a significant transaction. If it is a significant transaction, then we need to go into more formal purchase GAAP accounting in which you come up with some market value of the liabilities, and then set up your PVP asset and amortize off by using purchase accounting rules. Typically, in a purchase situation, you will not run into any goodwill. So it is just a matter of setting up liabilities and then setting up the PVP asset.

Moving on to federal income tax, for those of you who are not familiar with all the tax rules, let us go back to the basics. When Congress enacted Section 848, the DAC tax back in 1990, it required insurance companies to capitalize and amortize for federal tax purposes the policy acquisition expenses on a specified contract, on a straight line over ten years.

The inclusion of a reinsurance transaction under the DAC provision and the treatment of the consideration paid for reinsurance were controversial from the beginning. Some major issues were settled with the publication of final Treasury department regulations in December 1992. The general rule for reinsurance transactions after 1991 is that the ceding company reduces its gross amount of premium and other considerations subject to the DAC tax by the amount that it incurs as the net consideration for reinsurance. Correspondingly, the assuming company does the opposite. It includes the net consideration for the reinsurance and its gross amount of premiums and other considerations.

Let us think about Section 197. Dick talked about that a little bit. But let us talk about an example. First, we will talk about an example just using Section 848 only, and then let us bring in Section 197. The tax benefit granted to assuming companies under Section 848 can be demonstrated by this example. A reinsurer that assumed a block of individual life insurance policies on which the tax reserves were $3 million and that received consideration from the ceding company of $2 million would be required to capitalize and amortize over ten years $154,000. That is 7.7% times $2 million. However, the same company would also be allowed an immediate deduction of the $1 million ceding commission under Section 848.

With the enactment of Section 197, neither the tax benefit of this immediate deduction of the ceding commission nor the amortization of the ceding commission over the reasonable estimated life of the contract are available in assumption reinsurance transactions. In fact, the impact of the new Section 197 and the conforming amendment to Section 848 can be highlighted by returning to our example here. Given that the amount of specified policy acquisition expenses for the block of individual life contracts is $154,000 and that the ceding commission is $1 million, in our example, the amount subject to the Section 197 15- year amortization is $846,000. It is the $1 million less the $154,000. And the $154,000 remains subject to the ten-year amortization provided under the DAC provisions. Instead of the prior law in which the $1 million ceding commission was immediately deductible, the current tax act substitutes a 15-year amortization of this $846,000.

How many of you all have been involved in a purchase of blocks of business that are under rehabilitation? We have a few extra tax considerations for that. The assumption reinsurance of the business of a financially troubled insurer generally will produce a very large negative capitalization amount under the DAC rules, which might not be useful to the company in rehabilitation. If a company is going under, it probably does not need any of these tax benefits. The DAC regulations provide an opportunity for an insurance company under rehabilitation to shift a portion of its negative capitalization amount carryover to the reinsurer essentially. Specifically, the parties to a reinsurance transaction that is part of a rehabilitation plan can make a joint election under which the company with unused net negative capitalization amounts can forego the carryover of the portion of the excess negative capitalization and transfer it to the reinsurer. So you can come up with the value for it. You are getting to take advantage of the other company's negative.

Section 197 though does not contain comparable relief for assumption reinsurance transactions that are part of rehabilitation plans for insolvent companies. Thus, if the assuming company pays a ceding commission, such amount would have to be amortized over 15 years. Well, that does not sound very good. So how do people get around that? Well, interestingly enough, in many rehabilitation reinsurance transactions, no ceding commission is paid because the policy obligations are restructured prior to the reinsurance transaction in which assets are equal to the reserves that are transferred. Thus, Section 197 may not impose a tax cost for the parties to a reinsurance transaction in a rehabilitation process if you structure it this way.

That is a great deal of information and, as we have said, blocks of business are being bought and sold at a very high rate. Many details need to be considered and, unless we understand all these details—the statutory impact, the GAAP impact, the tax impact, and all the little nuances associated with each—it is almost impossible to value the block of business. I hope some of these ideas will give you a better understanding of purchasing blocks of business.

MS. GUINN: I have a couple questions. Dick, are there any rules of thumb about when it makes sense to elect a 338(h)(10)? Are there any characteristics that indicate when it may generate a net benefit to a transaction and when it is probably not appropriate?

MR. MILLER: The classic case when you want to elect a 338(h)(10) is if the company being sold has big tax-loss carryforwards. Tax-loss carryforwards get, if not wiped out, substantially impaired in a purchase transaction. If they can be utilized to consume the profit being generated by the assumption reinsurance treatment of the 338(h)(10), then the negative side of a 338(h)(10) can be neutralized. On the positive side of that tax equation are the deductions that are made available to the buyer going forward. There is a zero situation on the seller's side in which the tax income is neutralized by tax losses that otherwise would disappear.

On the buyer's side are tax deductions going forward, which the buyer is usually willing to pay for. So that is the classic rule of thumb. And it points to the proper direction for determination by the selling company of the appropriate tax treatment that the selling company wants to get into. Big unrealized capital losses in the existing portfolio might also trigger this consideration. They get into the values that will be put on the company as well, though, because realizing those unrealized losses will occur in the sale transaction for tax purposes, and the buying company will have a lower tax basis and will have lower, future deductions as they amortize their cost basis in those assets. So that one goes back and forth, but the tax loss is the classic rule.

MS. GUINN: Jim, I have one for you, too. Let us say you acquire a company at a price designed to get 12% return on cash, where by cash I mean cash available for distribution to shareholders. What approach do you recommend to achieve something close to a 12% return on equity (ROE)? Please cover that in two parts: *FAS 97* products and *FAS 60* products.

MR. WALLACE: Well, it is much more difficult than it once was. As you no doubt know, before the EITF came out, it was fairly common to hold statutory reserves as the purchase GAAP reserves, and then determine the present value of future profits on a statutory basis, which presumably was the underpinnings of the economics of the purchase price at a risk discount rate, and then amortize that present value of future profits at a risk discount rate. That is, you hold statutory reserves as your liability. You capitalize the present value of future profits on a statutory basis discounted at 18%, or whatever your risk discount rate was. You would then amortize that asset for GAAP by accreting 18% interest on it and then amortize an amount which, if all your assumptions worked out, would algebraically equal the actual emerging P-GAAP profits which, of course, are also your statutory profits. Then you would necessarily earn your risk discount rate, and that would achieve, I think, if I understood your question, the objective that you are after.

As you may know, Congress got involved and had hearings and, obviously, that had a lot to do with the EITF being issued and the way that profits are recognized after acquisitions. And so now you are limited to amortizing the value of insurance in force over premiums at the liability rate for *FAS 60* business and at the credited rate for *FAS 97* business. So my answer is it is much, much more difficult to do now than it would have been prior to the EITF.

FROM THE FLOOR: A very simple question. In your example of purchase accounting where you purchased a company for $125,000, after all the adjustments, you forced out a goodwill of, I think, $5,250. What if the purchase price had been $100,000 and you had a negative value? Can you carry that, and is that amortized into income? How often does that happen in practice?

MR. WALLACE: Well, it happens more often than you might think and for all sorts of reasons. You can end up with negative goodwill. There are accounting rules that tell you what to do with that. The first thing to do with negative goodwill, generally, is to begin eliminating intangibles. The obvious intangible is the value of the insurance in force. So generally, you would see companies offset the value of the insurance in force with a negative goodwill. Once you eliminate all the intangibles—if there is another accountant here who can correct me, please feel free to do so—and you end up with negative goodwill, then that gets amortized into income just like goodwill would. Someone is shaking his head no. Well, please correct that.

MR. DAVID Y. ROGERS: Jim, I believe that you then move to the next asset class, and there is a specific ordering that is fairly technical. I think of it as being distance from cash. So, first is intangibles, then followed by, say, real estate or other noncash-type assets, and then all the way down to actual cash.

MR. MARK E. KONEN: Dick, you referenced Colonial American on the non-DAC-able indemnity reinsurance. Is there any precedent or place where you could just take the deduction and go on your merry way?

My second question relates to negative goodwill, or negative ceding commissions under Section 338. What do you think a defensible position is that a company might take on that, and do you think there will ever be any regulations or clarification that would not lead to the illogical result of looking at income?

MR. MILLER: Regarding the first question, is there a way to get around the requirement to capitalize and amortize? Yes. I did not mention it, but Treasury regulatory rulings have generally allowed ceding commissions that arise in the normal issue of new business to be immediately deductible. If your coinsurance agreement includes new business being written with ceding commissions being paid at that time, then those ceding commissions would be deductible immediately. So they would not be capitalized separately as an asset. This ignores any DAC effect. Beyond that, if it is a true block of business and there is no continuing new business going into it, I would expect the Treasury to prevail. I have not heard of anybody being able to structure a block reinsurance in a fashion to avoid that construction.

Now let me get back to the question of the negative ceding commission under Section 338 and whether the complications there might be avoided. I think it is valid to speculate—that is all I am doing—that Treasury will come out with a ruling on Section 197 that gives primacy to Subchapter C and says if it is a capital transaction, you do not have any current net income or loss generated by the transaction.

If you buy an asset, you put on your books an asset at a tax-cost basis, and you have on your set of books some kind of liabilities or net worth that are equal, and you have no income or loss at that point in time for tax purposes, it is a capital transaction.

The word I have from one of the people who is very influential in writing the regulations is that this interpretation is his personal opinion, and that it is strongly the opinion of the Subchapter C people, and it makes better sense. It really does make better sense.

If they do go that route, for consistency sake, they would then probably have to go back and completely remake Regulation 1.817(D)(4). It was promulgated in 1972 and dealt with assumption reinsurance. Assumption reinsurance is quite obviously a classic capital transaction. The 1972 ruling requires that everything go through the income statement rather than just be treated as the tax basis of assets. This is contrary to Subchapter C. When will we get such a ruling? It was supposed to be out early this spring.

MR. MILLER: I have one question on goodwill. I have understood that the EITF was getting somewhat sticky about 40 years, and goodwill had to be amortized over a reasonable lifetime of the underlying business. Do any of the two accountants want to speak about that?

MR. WALLACE: There is definitely a movement toward shorter periods for goodwill amortization, and the rules are still the same. That is, you have to use a rational systematic pattern over no more than 40 years, and that has not changed. There has been one change. There is a new *FAS* on impairment of long-lived assets, and so goodwill will have to be looked at in terms of recoverability and that, inherently, may cause a shortening of the period. But the rules are what they have always been: no more than 40 years. But, nonetheless, it is not uncommon to see 20 years as the period picked rather than 40.

I might make one request of this group because you all are involved in transactions. All my comments were purely my own opinion. I want to be clear about that. But I am on the Academy Committee on Life Insurance Financial Reporting (COLIFR), and we are very interested in looking for examples of having difficulty applying *FAS 113* to insurance products. The AICPA has a draft statement of position (SOP) that has been issued on deposit accounting for reinsurance transactions, which commonly are used, obviously, to sell blocks of business. There are many situations in which you just cannot apply *FAS 113* to property casualty business.

The SOP currently does not address life business, and the Academy is concerned that we should be thinking about that. We are looking for examples of the difficulty in applying *FAS 113* on life products. Commonly, it comes up in annuities. Annuities generally are investment contracts, they do not qualify for *FAS 113*, and they are out of it. So in a sense, there are no rules other than deposit accounting, which just is not defined, on accounting for *FAS 113*. So to the extent you have encountered such problems, please let the COLIFR know.