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

REVIEW BY:

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The reviewer is a Fellow of the Casualty Actuarial Society (1977) and is a Commercial Actuary with Allstate Insurance Company. Academic degrees are B.A. University of California, Riverside, 1967; and Master of Business Economics, Claremont Graduate School, 1970. The reviewer was the author of a paper "A Constrained Profit Maximization Model for a Multi-Line Property/Liability Company" presented for the CAS 1979 Call Paper Program, "Total Return Due a Property-Casualty Insurance Company".

I would like to express appreciation to the authors for providing an informative discussion of insurance company acquisitions and related tax considerations.

The authors point out that Insurance Companies have certain "identifiable intangible assets" that do not appear on their balance sheets, but which are real and have value. These assets should be considered by both seller and purchaser in an insurance company acquisition, and via the "Section 338 Tax Election" their amortization may provide tax benefits to the acquiring company after acquisition.

It may be noted that the tax benefit of amortization of "Value of Future Profits in the Loss Reserves" will probably be lost if the federal tax code is changed to require booking of reserves on a discounted basis. This is because the write down of this asset after acquisition would be offset by its continued replenishment from operation of the acquired company after acquisition.

Be that as it may, I made up a hypothetical example of how the 338 Election would provide tax benefits under current regulation. My example is based solely on inferences drawn from the paper, and is intended only for discussion purposes. For the purpose of simplification, I chose to develop in my example only one "identifiable amortizable intangible asset", which will be "Value of Future Profits in the Loss Reserves". This asset to me is the same as discount of loss reserves because of future expected investment income. It will be carried as an asset in the example.

Suppose the "Steady State Insurance Company" operates every year with the balance sheet and income statement below.

Steady State Insurance Company
(Pre Acquisition)
Balance Sheet
($ Millions)

Assets	Liabilities
$180 bonds	$30 UEPR
(12% taxable yield)	$120 Loss Reserves
	$30 Equity

Income Statement
($ Millions)

Revenues		
Premiums Earned	$60	
Investment Income	21.6	
		$81.6
Expenses Incurred		
Losses	$48	
Underwriting Expense	18	
		$66
Net Income before Tax		$15.6
Income Tax (46% rate)		7.2
Net Income after Tax		$ 8.4
Shareholder Dividends		$ 8.4

Now suppose an acquiring company pays $60 million for the company. This is more than current book value of $30 million, so there is a tax benefit to be gained by the 338 election. Using an assumed payout pattern for current loss reserves and discounting at the 12% yield rate of the current portfolio, I determined that a fully discounted reserve would be $94.3 million. The difference between this and the carried reserve is $25.7 million, and via the 338 Election this amount becomes an asset that can be written off on future tax returns.

An amortization schedule is developed based on the 12% investment yield and the expected payout pattern. The amortization schedule is simply the Investment Income column in the table on the next page. Each year's investment income is

12% of the beginning discounted loss reserve (losses are assumed paid out at the end of the year), and the ending discounted loss reserve is the beginning reserve plus investment income less losses paid.

Discount of Loss Reserves
Amortization Schedule

Year	Discounted Loss Reserve Beginning Balance	Investment Income (to be amortized)	Losses Paid	Discounted Loss Reserve Ending Balance
1	$94.3	$11.3	$ 43.2	$62.4
2	62.4	7.5	33.6	36.3
3	36.3	4.4	24.0	16.7
4	16.7	2.0	14.4	4.3
5	4.3	0.5	4.8	0
		$25.7	$120.0	

One year after acquisition, we have the following Income Statement applicable to the tax return. We have written off the first $11.3 million of the Discount of Loss Reserves. Net Income before tax is reduced to $4.3 million versus $15.6 million in pre-acquisition days, and the company has a first year tax savings of $5.2 million.

Steady State Insurance Company
(Post Acquisition - 1 Year Later)

Income Statement
($ Millions)

Revenues		
Premiums Earned	$60	
Investment Income	21.6	
		$81.6
Expenses		
Losses & Loss Expense	$48	
Underwriting Expense	18	
Amortization of Reserve Discount	11.3	
		$77.3
Net Income before Tax		$ 4.3
Income Tax (46% rate)		2.0
Net Income after Tax		$ 2.3

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The company would continue to write off the discount in succeeding years according to the amortization schedule.

I hope my example serves to illustrate the ideas discussed in the paper, or will stimulate discussion of the paper. The specific techniques in my example are purely my own and have not been verified either by the authors of the paper or the IRS. I would advise anyone contemplating their use to consult appropriate tax counsel.

In addition to "future profits in the loss reserves", the authors also identify "future profits in the unearned premium reserve" and "future profits on renewal business" as possible amortizable intangible assets. These require more things to be assumed to develop an asset valuation. The profit in the unearned premium reserve item requires a projection of claims that have not occurred yet, and possibly also midterm cancellations of policies. The future profits on renewals item requires projection of renewal retention ratios, future price levels, future claims, and future investment returns. The retention ratios and price levels would depend upon future market conditions and/or future management actions.

Again, I would like to thank the authors for opening a window into the world of acquisitions and related tax strategies. Upon reflection, it can be seen that there is much work for actuaries to do in insurance company valuation, whether the estimated items are used for tax reasons or simply to determine the value of the company.