CEA Insurers of Europe

CEA Response to US Senate Finance Discussion Draft to disallow the deduction of reinsurance premiums with respect to United States risks paid to affiliates

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Related CEA documents:	CEA letter on Discriminatory Reinsurance Tax Proposals dated 18 December 2008, MU 8297		
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1. Introduction

As a follow-up to our letter dated 18 December 2008 (reference MU 8297) and in response to the publication of a Senate staff discussion draft of a proposal amending the Internal Revenue Code of 1986, to place limitations on the deduction for certain reinsurance premiums paid to affiliates ("Draft Proposal"), the European Insurance and Reinsurance Federation ("CEA") is taking this opportunity to explain its concerns and strong opposition to the Draft Proposal.

The Senate Finance Committee proposes to modify the tax treatment of reinsurance premiums paid to related parties headquartered offshore for taxable years beginning after 31 December 2008 and it plans to use public comment to further its understanding about the potential implications of such tax code amendments for insurance companies and consumers alike. The Committee encouraged the submission of public comments including, but not limited to, remarks addressing:

a) the possible effect on insurance pricing and capacity;
b) issues relating to existing treaties and sovereignty rights of other jurisdictions;
c) the potential impact of the proposal on the reinsurance market;
d) American competitiveness;
e) possible impact on the crop insurance market; and
f) the effective date of the proposal.

The CEA believes the Draft Proposal imposes a punitive, discriminatory "tax" on foreign insurance and reinsurance companies, as the proposal would only apply to affiliated reinsurance with *foreign* reinsurance. If enacted, the Draft Proposal will increase the cost of US insurance coverage, further straining US consumers and businesses currently struggling in a severe recessionary environment. Given its concerns, the CEA maintains its strong opposition to the Draft Proposal, or potential similar legislation, for the reasons detailed below.

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2. The negative impact of the proposal on the reinsurance market

Role of foreign-based reinsurance in the US economy

Reinsurance is used for economic reasons – not for tax purposes. It is a necessary tool for risk management and for increasing gross underwriting capacity. Reinsurance is necessary for any insurance company to manage its risks and is therefore used for valid business reasons, eg to provide additional capacity, to allow a company to lay off risks that fall outside its underwriting parameters while retaining other insurance business, to allow a company to enter new lines of business, and to protect against losses that could threaten a company's solvency. On the other hand, reinsurance buyers require highly capitalised companies that can sustain major losses without risk of insolvency.

Affiliate reinsurance is used for the same purpose as third-party reinsurance: it provides additional capacity and protects in the event of loss (through the use of diversification effects). Furthermore, it may allow certain types of risks to be pooled in an insurance group, and thus create insurance capacity in cases where, without reinsurance, insurance would not even be offered or would be too expensive. Whether with an independent third party or an affiliate, reinsurance is therefore clearly not designed for tax avoidance. US tax authorities and insurance regulators closely scrutinise affiliated reinsurance transactions to confirm whether appropriate business purposes and risk-transfer conditions exist.

Current figures show that affiliate reinsurance transfers substantial economic risks. The Reinsurance Association of America (RAA) data on offshore reinsurance in the US market for 2007 (RAA Data) (Annex 1), in particular on affiliated offshore reinsurers, show that net recoverables of $74 489 million were reported in 2007 compared with ceded premiums of $33 786 million in the same period. The same data also show that in 2006 net recoverables of $70 404 million were reported compared with ceded premiums of $32 470 million in the same period.

Given the above figures, it is clear that the European reinsurers often suffered heavy losses from affiliate reinsurance in the US, and without this reinsurance, US tax revenues would have been lower.

The US market needs a significant amount of reinsurance capacity. A considerable amount of reinsurance acquired each year by US insurance companies is from non-US reinsurers. The IAIS Global Reinsurance Market Report 2008, issued in December 2008, clearly shows that European reporting entities were a net recipient of risk, with a positive premium balance between gross written premiums assumed and ceded of $35.2 billion. In contrast, North American reporting entities were, as a whole, a net cedant of risk with a negative premium balance of $14.9 billion.

For example, two-thirds of reinsurance to protect insurers of homes and businesses in the US from hurricanes and earthquakes is sold to non-US reinsurers. Foreign reinsurers write business in particularly high risk sectors, eg volatile, high severity, low frequency business like property catastrophe (hurricanes, earthquakes), medical malpractice, directors and officers' liability, and crop insurance. Foreign reinsurers provide capacity for state windstorm pools, for homeowners threatened by Atlantic Coast hurricanes and California earthquakes. Significant portions of the US market for these hard-to-place lines of business are thus supplied by European insurance companies.

The 11 September 2001 tragedy made clear the importance of non-US insurance and reinsurance to the US economy, since more than 60% of the World Trade Center claims were paid by non-US reinsurers. As a further example, approximately 50% of Hurricane Katrina claims were paid by non-US reinsurers.

Thus, especially in view of the catastrophes of the last decade, European reinsurers provide an essential share of US catastrophe reinsurance and have often suffered heavy losses from reinsurance in the US. The introduction of a discriminatory tax would negatively affect the availability of reinsurance.

3. American competitiveness

Proposal distorts competition and does not lead to a level playing field

Reinsurance premiums, whether paid to an independent third party or to affiliated US reinsurers, are business expenses and therefore tax deductible. The ceding insurer receives a ceding commission, which is taxable in the US, and the reinsurance premiums are taxable income in the reinsurer's country of residence. In the case of reinsurance, any losses have to be borne by the reinsurer, thus no recognition and no tax deduction of these losses in the hands of the US ceding company arises, as any reinsurance recoveries are included in the ceding company's income. Therefore, reinsurance does not mean "shifting income" to another country, but the transfer of risk, and higher taxable income in the US in those instances where the business turns out to be non-profitable or even loss-making. This clearly differentiates reinsurance from financing and therefore, it is inaccurate to characterise reinsurance as "transfer of a stream of positive income". Moreover according to recent experience and statistics, an opposite stream of income has been registered, since European reinsurers have recently suffered heavy losses from reinsurance of US risks.

The proposed limitation of reinsurance premium deductibility to the industry average would disallow affiliate reinsurance deductions if even modest amounts were reinsured. In effect, the bill assumes that any reinsurance with a foreign affiliate is abusive; an interpretation that is clearly wrong. As a consequence, it creates double taxation, which puts foreign reinsurers at a disadvantage compared to US reinsurers.

Moreover, if the Draft Proposal was adopted, it would restrict the ability of US insurers to accept certain types of risk and limit their ability to use capital efficiently. It is worth noting that many of the US companies in favour of this proposal use affiliate reinsurance extensively so that they can pool similar business and employ capital efficiently. **Therefore, the Draft Proposal would not contribute to creating a level playing field; on the contrary, it would deliberately reduce competition in the US**.

4. The possible effect on insurance pricing and capacity

Foreign reinsurance is advantageous for US consumers

The Draft Proposal would impede access to essential capital needed by US insurers, would prevent companies from making efficient use of capital and would lead to a reduction in the capacity of US insurers, to the detriment of US customers, whether domestic or business. The Draft Proposal would inhibit their ability to offer insurance protection, therefore reducing competition and as a result increasing US market prices. Additionally, reduced competition allows US (re)insurers to enjoy relief from competitive pressure on insurance rates, an effect that also leads to raised prices for US consumers. Particularly during a recession, tax policy should not create impediments to competition in the US market that would increase costs or reduce coverage for consumers.

Furthermore, without foreign reinsurance, consumers would have greater difficulty finding adequate insurance for their specific risks.

Finally, the proposal would severely restrict access to global capital, a scarce resource considering the current financial market turmoil, and it would not save or create a single extra US job but rather increase the price of insurance for US consumers.

5. Issues relating to existing treaties and sovereignty rights of other jurisdictions

Proposal causes double taxation

The Draft Proposal would limit the deductibility of insurance premiums paid to non-US affiliates and would lead to double taxation, given their inclusion in taxable income in the reinsurer's country of residence. Even if claims payments are made later on, these payments are treated as income in the US – notwithstanding the fact that the reinsurance premium has never been tax deductible. This clearly demonstrates the flaws in the Draft Proposal.

Proposal violates US double tax treaties

The non-deductibility constitutes a clear violation of tax treaties signed by the US. The Draft Proposal deviates from the non-discrimination principle and is therefore inconsistent with decades of US tax and trade policy. In particular, it contradicts existing US OECD-based double taxation treaty obligations and WTO commitments.

In particular, the Draft Proposal violates treaty rules designed to prevent discrimination against foreign-owned companies. Under the proposal, the US insurance affiliate of a European company would lose the deduction for affiliate reinsurance. This denial would violate the non-discrimination provision of the prevailing Double Tax Treaty.

According to Art. 24 Sec. 1 OECD Model Convention, *"nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected."*

As further explained in the commentary on Art. 24, *"this paragraph establishes the principle that for purposes of taxation discrimination on the grounds of nationality is forbidden, and that, subject to reciprocity, the nationals of a Contracting State may not be less favourably treated in the other Contracting State than nationals of the latter State in the same circumstances."*

As an example, the Draft Proposal violates Article 24 Sec. 3 of the Double Tax Treaty between the US and Germany that provides that "disbursements" paid by an enterprise of one treaty country to a resident of the other treaty partner *"shall, for purposes of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State."*

It also violates the provisions of the Double Tax Treaties signed by the US with several European countries, such as Germany, France, Switzerland, Italy, Ireland and the UK, based on article 24, paragraph 5 of the OECD Model Convention, stating that *"Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith that is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected."*

The Draft Proposal would not only penalise foreign-owned insurers for reinsuring with affiliates, but would also allow their US based competitors to reinsure with the same jurisdictions without penalty. **It therefore creates inconsistent and unfavourable treatment for foreign-owned companies, while permitting US-owned companies to take advantage of placing reinsurance with a foreign tax jurisdiction.** Whereas European reinsurers and their US-affiliated insurers would therefore suffer from the denial of reinsurance premiums, their US competitors would be able to take the deduction – not only a clear violation of the Double Tax Treaties, but also further proof of the violation of a level playing field in the US insurance market, as previously described in point 3. Ultimately, affected countries may retaliate with tax laws aimed at US companies.

6. US has adequate tools to deal with "income shifting" already in force

The Draft Proposal would infringe the long-term tradition of US tax policy which is based on the arm's-length standard for related-party cross-border transactions.

Reinsurance is fundamentally different from earnings stripping

"Earnings stripping" involves the transfer of (positive) income via interest payments to a foreign affiliate. In contrast, because reinsurance involves "risk transfer" and not financing, reinsurance may involve the transfer of losses to a foreign affiliate. Whether or not the contract is profitable becomes apparent only afterwards; the assumption that reinsurance always results in profitable business is wrong. Although the reinsuring company expects that it has written profitable business, the outcome may vary substantially from the projections of profit at the time the business was written.

The Draft Proposal assumes that all reinsurance is profitable and wrongly considers all affiliate reinsurance doubtful or even abusive. Therefore the formula proposed in the bill is punitive and effectively disallows affiliate reinsurance deductions, even where modest amounts of reinsurance are placed with an affiliate.

Transfer pricing rules are adequate means to combat not dealing at arm's length

The transfer pricing rules of US Internal Revenue Code § 482 already empower the IRS to make adjustments necessary to prevent tax evasion or more clearly reflect income earned by US companies. In addition, the special rules of US Internal Revenue Code § 845 on related-party reinsurance further allow the IRS to make adjustments to fully reflect the income of the US insurance company. In the American Jobs Creation Act of 2004, these related party reinsurance rules were amended to further strengthen the IRS's authority to enforce arm's-length pricing in affiliate reinsurance contracts. Considering the above, the current US law already comprises adequate tools to deal with "income shifting" by a US insurance subsidiary to a foreign affiliate reinsurer. No more specific measure is needed.

Foreign-owned companies annually prepare the necessary studies to support their transfer pricing of affiliate reinsurance, and these are available to IRS agents in tax audits. Their tax directors are very much aware of the need to price and document inter-company transactions, such as reinsurance, correctly.

7. The European tax jurisdictions represented by CEA

European Union (EU) countries, especially the main reinsurance markets, are not low-tax jurisdictions

Although not expressly said in its text, the purpose of the Draft Proposal is to prevent income shifting from US to foreign low and no-tax jurisdictions.

Cross-border reinsurance, whether with a related or unrelated party, moves the risk of loss to the non-US entity. Profits or losses on premiums associated with this risk are respectively taxed or deducted abroad where the risk now resides and, specifically in the European countries represented by the CEA, the reinsurance premiums paid to reinsurers are subject to local corporate taxation.

In this context, it is worth noting that the average tax burden within Europe amounts to approximately 25%, comparable to US corporate effective tax rates, and is even higher in the most common reinsurance markets.

If the Draft Proposal came into force, especially with regard to Europe, the violation of double tax treaties would therefore lead to a punitive taxation of reinsurance premiums.

EU takes care of harmful tax competition

Moreover, the EU has several political instruments in force to prevent harmful tax competition with regard to the tax base. One example is the Code of Conduct for business taxation set out in the conclusions of the Council of Economic and Finance Ministers (ECOFIN) of 1 December 1997 ("the Code"). Although the Code is not a legally binding instrument, it has political force.

By adopting the Code, the EU ECOFIN Council recognised and welcomed the positive effect of fair competition. The Code was specially conceived to spot the measures that unduly influence the location of business activity in the EU by being aimed only at non-residents and granting them a more advantageous fiscal treatment than that which is normally available in the Member State concerned. To identify such harmful measures, the Code determines the criteria against which any potentially harmful measures are to be tested and requires Member States to abstain from establishing any new harmful tax measures ("standstill") and alter any laws or practices that are considered to be harmful in respect of the principles of the Code ("rollback").

Taking the above facts into account, the CEA is convinced that a general, imprecise and inaccurate reference to affiliated reinsurance should be regarded as disproportionate and unjustified.

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The CEA remains at your disposal and looks forward to assisting the US Senate in all the issues mentioned above, as well as in any other questions that arise in the course of discussions.

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