110TH CONGRESS SENATE
2D SESSION – STAFF DISCUSSION DRAFT
AFFILIATED REINSURANCE
PREMIUMS

The following are the personal comments of the undersigned who had a history and career experience in the international insurance industry and with a U.S. based multinational relating in part to the earlier development and application of the prior provisions of the various laws leading up to the Senate Finance Committee Discussion Draft to amend the Internal Revenue Code to disallow the Deduction of Excess Non-taxed Reinsurance Premiums.

The comments will critique the technical explanation of the suggested draft legislation provided by the committee and suggest some inequities to the proposed solution if one is considered necessary or appropriate in this instance.

HISTORY

From a general policy prospective, when considering the proposed amendment, the committee should recognize that the proposal is an exercise to increase tax costs on cross border transfers of reinsurance risks. Such additional costs tend to reduce the ability to spread risks by increasing the cost of the home ceding company country, in shifting such risks to capital located outside the country of origin. In the past, similar cross border taxes or proposed denials of tax deductions for affiliated reinsurance premiums were levied or proposed in France, and Japan only to be dropped shortly thereafter, or not adopted on further reflection by the fiscal authorities in such countries. Generally, free trade principles, non-discriminatory tax treaty concerns or damage to the ability to spread the ceding countries' risks because of prohibitive tax cost were the reasons for reconsideration by the countries. In the case of France, the policy led to such a concentration of risk retained in France that successive winter storms damaged the local industry because the tax policy inhibited the ability to spread risk beyond the French/European insurance sector.

Another example, a very similar proposal to the current one before the Senate Finance Committee was floated in 1992 by the Japanese Ministry of Finance (MOF) to deny a Japanese corporate tax deduction for related party Japanese risk reinsurance premium ceded from a Japanese subsidiary to affiliated companies outside Japan. It was opposed by the U.S. Senate leaders at the time, the Honorable George Mitchell (D) Maine, and Robert Dole (R) Kansas, and others, as well as Treasury Secretary Nicholas Brady: The provision was eventually withdrawn from consideration by the MOF.

The Japanese government fell back on their mirror image adoption of U.S. I.R.C; Section 482, the appropriate arms length pricing provision, as the proper internationally acceptable tax provision to enforce transfer pricing to related party reinsurance transactions. The Japanese accepted the potential international tax treaty discrimination, and protectionist/restraint of trade arguments the U.S. government presented to them at the time to drop the legislative proposal which would have denied a tax deduction for related party reinsurance. The Japanese did not see

a need for additional tools similar to I.R.C. Section 845 nor the subsequent modifications to I.R.C. Section 845 in 2004 which the IRS already has in place beyond I.R.C. Section 482 to deal with related party reinsurance.

NATIONAL TREATMENT AND NON-DISCRIMINATION

The proposal before the Senate Finance Committee is much more complex than the Japanese proposal referred to. It attempts to create an artificial and convoluted way to comply with the non-discrimination provision of the U.S. bilateral tax treaties and to a significantly lesser degree the accepted U.S. trade reservation on the Federal Excise Tax conceded in the GATS negotiations by the U.S.T.R. to be no more than 1% of gross premiums for all U.S. cross border reinsurance transactions including related party transactions. A denial of the tax deduction for related party ceded reinsurance against a 35% corporate U.S. tax rate would effectively prohibit related party reinsurance, since it would, in effect, increase the cross border tax on affiliated reinsurance from 1% of gross premium ceded to 36%. In effect, the proposal exponentially increases the cross border tax cost which the U.S. committed to retain at 1% of gross premium at the GATS. The exponential tax increase breaks the accepted business model which internationally based insurance and reinsurance companies use to deploy limited capital efficiently by centralizing the reinsurance in one location; usually at the head office where management expertise and capital is concentrated.

Section 6 of Article 24 of the model income tax treaty states that Enterprises of a Contracting State, the capital of which is wholly owned by a resident of the other Contracting State shall not be subjected in the first Contracting State to any taxation or any requirement connected therewith, which 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. It would appear that Section of 6 of Article 24 is the non-discrimination section of the treaty which may be violated by the Senate discussion draft, as a cession among domestic insurers does not create the prohibitively high tax cost by denying premium tax deduction as when ceded to the owner of the capital situated in a treaty country contracting state.

It should also be pointed out that the JTC reference to “fronting” in the reinsurance context is not analogous to the industries’ concept where 95 to 99% of the premium would be ceded from the front company to the reinsurer. The industry related party reinsurance transactions are not remotely similar to fronting, since the net retention of the U.S. ceding company is always far greater than 1 to 5% of premium.

The committee’s technical explanation cites paragraph 1 of Article 9 and Article 24 paragraph 1 of the Treasury department model income tax convention to attempt to show that the proposed amendment does not discriminate against U.S. Treaty partners. In doing so, it ignores the fact that U.S. domestic group insurers have related party reinsurance arrangements for the same good business reasons with their other affiliated domestic companies as a common business practice in order to spread the risks underwritten to other capital within their domestic group of companies; i.e. to satisfy both state insurance regulations and the rating agencies. The rating agencies require a spread of risk to separate companies within a group of companies through related party reinsurance in order to maintain the highest ratings for all companies within

a consolidated group. Without spreading the risk through related party reinsurance pooling, the rating agencies would most certainly lower the ratings of companies within the group, which would limit their ability to compete to obtain such business because of the lower ratings. Similarly, U.S. state insurance regulations require each company licensed in the U.S. within an affiliated group of companies to have its balance sheet, solvency margins and capital surplus stand alone and be measured separately on a non-consolidated basis. These are the legitimate non-tax business reasons for related party reinsurance, not the contrived reasons referred to on page 59 of JTC report (JCX-87-07 Sept.26, 2007). Related party reinsurance ceded to a foreign parent is not placed to take advantage of lighter regulation in a more business friendly regulatory environment or to minimize multiple layers of regulations, but to satisfy the rating agencies to maintain the highest ratings for the domestic subsidiaries within their group of companies, and to satisfy regulatory requirements that prohibit a concentration of risk or encourage a spreading of risk. All major reinsurance centers including Japan, Switzerland, UK, Ireland, Germany, Bermuda and France are subjected to a common and uniform body of regulatory standards and principles adopted several years ago by the International Association of Insurance Supervisors, accepted and implemented by the insurance regulator in each jurisdiction and policed periodically by International Monetary Fund reviews to assure compliance.

"GROUP OF 20" AGREEMENT AGAINST PROTECTIONIST PROPOSALS IN 2009

The committee's permanently non-deductible treatment of related party reinsurance premium, in its staff draft, breaks the use of the traditional international model of reinsuring back to the head office capital base, and acts as a protectionist restraint on trade in services on the foreign located reinsurance group. The "Group of 20's" Nov.15, 2008 gathering agreed to immediate steps to restore growth within stagnating and collapsing world capital markets, which included a rejection of protectionism and a refrain from imposing new trade barriers for the next 12 months. The Senate Finance Committee staff draft clearly falls into the category of protectionism and acts as a trade barrier which the U.S. acknowledged as part their GATS concession in 1994 for the cross border taxation of reinsurance premium at no more than 1% of gross premium. Denying deductibility of cross border affiliated premium is another method of increasing protectionist taxation on U.S. situs reinsurance ceded abroad which the U.S. rejected at the GATS. The 1% of gross premium tax on reinsurance is presented in the press release accompanying the staff draft as a tax in lieu of U.S. income tax. It is set at the rate of 1% because it applies on a gross basis without deductions, is permanent, i.e., does not take into consideration whether the business incurs real normally tax deductible economic losses exceeding net income. It also implicitly recognizes the significant state gross premium taxation of the direct business of domestic companies, by setting a 3% rate differential between direct and reinsurance federal excise tax. The "Group of 20" agreement to refrain from considering new trade barriers for the next 12 months should be respected.

When related party reinsurance is being placed with a foreign parent or sister company, the U.S. ceding company is gaining a substantial qualitative profit advantage. By trading from its books an unknown result because of the risk of real economic loss on the business ceded in exchange for earning a positive commission differential, a taxable profit is almost certain to the domestic ceding company. The arms length pricing on this commission differential is easily measurable by industry standards and assures a taxable profit to the U.S. government. What has

occurred is an export sale of the risk of loss shifted from domestic capital and reserve to foreign capital and reserve. I.R.C. Sections 845 and 482 are the appropriate measures of the taxable profits of the domestic ceding company as in any other export sale or service transaction between related parties.

By denying a deduction for related party reinsurance, the U.S. government takes the most draconian approach to punishing the foreign capital model since the tax is applied without consideration to either large tax deductible loss reserves on the business or actual deductible future losses, which may exceed the reserves. The denial of the deduction appears to be a permanent tax differential that does not factor in future losses on such business which would be available to a group of purely domestic related insurers. Even the ability for the foreign affiliates to make an I.R.C. Section 953(d) domestic election favors the domestic industry since electing foreign companies can not be consolidated with their domestic ceding insurance affiliates. A 953(d) election would also capture business from other foreign countries not normally subject to U.S. taxation, since the entire income of the electing company is subjected to U.S. taxation.

ANALYSIS OF DISCUSSION DRAFT

Using a two year old industry average by specific line of business to determine the amount of permissible non-tax effected reinsurance that can be placed destroys the judgment, flexibility, and in many instances, the growth potential of a particular company since no two companies are at the same stage of capital availability, particular line of business development, nor can they accurately predict to what extent which particular lines of business will grow or recede in the second succeeding year. Using a two year old industry average by particular lines of business is a meaningless statistic to apply to particular company model and is merely an arbitrary and artificial measure of reality.

EARNING STRIPPING ANALOGY

The tax committee technicians used earnings stripping concepts applied to related party capital (debt) transactions (which shifted interest income) as the analogy for the proposed related party reinsurance legislative discussion draft, yet they failed to consistently follow it. They should have provided an equivalent carryover provision as is available for non-deductible excessive interest to take into account the tax deductibility of loss reserves, unearned premium reserves or the potential for real economic losses, which the foreign affiliate may incur on the business ceded to it. The whole ceded premium received by the foreign affiliate is simply treated as permanently not deductible under the proposed draft. Since the business ceded to the foreign affiliate ultimately may incur economic loss, a permanent loss of tax deductibility does not reflect economic reality. Unlike the earnings stripping concept where a fixed amount of determinable income is shifted to the foreign affiliate, the income or loss shifted by a related party reinsurance transaction is not determinable.

The analogy to earnings stripping of tax deductible interest does not hold water since the premium being denied deduction carries with it significant potential losses and claim expenses and other immediately tax deductible items such as unearned premium and loss reserves. Similarly, the dictate of insurance regulations and rating agencies create both the need for, and in

many instances, the level of related party reinsurance to foreign affiliates. The foreign owned insurance group shares a common problem with the U.S. domestic owned group; an absolute limitation on capital, and the need to satisfy insurance regulations and rating agencies on the most efficient allocation of such capital. Concentration of diverse risks from various geographic locations by bringing it back to a central location of the parent company is the most efficient model for utilization of capital and spreading or balancing risk. The earnings stripping concept currently in the code applying to interest is a method to tax a shifting of income that does not carry with it significant amounts of real economic tax deductible items and the possibility of real economic law.

> Assuming the earnings stripping approach to related party interest still were considered by the Committee as an applicable analogy to real risk shifting reinsurance transactions three elements should be considered which are not included in the staff draft. 1) An analogous safe harbour provision to the debt equity principles as applied to interest would need to be considered. 2) There should be a full dollar for dollar tax credit of the 1% Federal Excise Tax paid on the related party reinsurance transaction. 3) Finally, indefinite carry forward provisions should apply to the real economic loss elements of the related party reinsurance transaction.

Debt/Equity Safe Harbor Analogy. As part of the National Association of Insurance Commissioners early warning system applied for measuring the solvency of insurers and reinsurers under U.S. state insurance regulations, a net premiums earned to surplus ratio was adopted as a measure of adequate capital and surplus, which at a minimum, an insurer should maintain. This ratio was conservatively set at 3 to 1, so that for every 3 dollars of net earned premium an insurer retained after reinsurance, at least one dollar of capital and surplus should be maintained by the insurer. This concept was adopted into U.S. tax legislation in 1976 to permit U.S. controlled foreign corporations to defer U.S. taxation on an amount of investment income derived from the minimum necessary capital an insurer or reinsurer needed, as an insurance regulatory matter, to actively conduct its insurance business. (See current section 954 (i)(2)(B)(C) and the Committee reports surrounding the 1976 Tax Act for background). The concept was carried forward to a narrower definition of deferred active insurance income limited to risks situated in the same country of incorporation. However, the tax code measure of active insurance investment income from an insurer's minimum necessary capital remained constant. Necessary capital is measured to be one third of net earned premium. Since this is a well established principle in the tax code to measure active investment income from the necessary capital of an insurer based on a U.S. state early warning solvency indicator, it should be adopted as part of a safe harbour to measure the maximum amount of premium that a U.S. ceding company could retain before applying the non-deductibility earnings stripping concept to an amount of reinsurance ceded from the domestic company. For example if the domestic ceding company had a 2-to-1 retained premium to surplus ratio after all reinsurance, including related party premium, no affiliated foreign reinsurance should be considered non-deductible in fact, an additional dollar of related party reinsurance should not be considered non-deductible for each dollar of surplus retained by the domestic ceding company under the safe harbor concept. In this example, the domestic ceding has excess capital in the U.S., where the investment income from it is subjected to U.S. corporate tax. The U.S. company could have carried additional premium on its books without breaking the early warning system solvency test adopted by the U.S. tax

code under Subpart F. The U.S. ceding company is already paying U.S. tax on the investment income from the capital needed to carry the portion of the related party reinsurance ceded to the foreign affiliate.

The 3-to-1 net premiums to surplus test is merely one of many indicators that regulators of National Association of Insurance Commissioners use to determine whether a company was in acceptable financial condition. It was chosen in the 1976 tax act as a minimum capital test because it treated as active business insurance investment income the least amount of investment income from capital that an insurer should have relating to net premium writings. By choosing this test as a safe harbor, the Congress would be applying consistently a rule which has been longstanding as a part of the Internal Revenue Code. Most companies maintain more capital surplus in relation to their net premiums retentions in conducting their business to help to achieve the highest insurance ratings possible from the ratings agencies in order to attract quality business.

DOLLAR FOR DOLLAR CREDIT FOR F.E.T. PAID

Secondly, the committee clearly recognized the 1% gross premium federal excise tax on reinsurance is a tax in lieu of an income tax. Therefore, a dollar for dollar credit should be provided against the additional potential tax liability generated by the non-deductibility of related party reinsurance, since a fixed, non-refundable U.S. income tax, in effect, has already been paid on the business ceded to the foreign affiliate in the form of the 1% excise tax. A double U.S. tax should not be payable if some form of legislation denying deductibility for related party reinsurance is adopted.

CARRY FORWARD EXPENSES ATTRIBUTBLE TO RELATED PARTY REINSURANCE

Finally, the amount of non-deductible related party reinsurance carries with it the risks of real economic and normally tax deductible losses, which could completely eliminate any potential U.S .tax on profits artificially generated by denying such deductions. Therefore, potential for the use of these losses should be recognized by an indefinite, unlimited carry forward of such non-deductible items.

In addition, if the committee decides to establish some form of the 50% limitation for “adjusted taxable income” analogous to I.R.C. Section 163 (j), [the earnings stripping calculations for interest] then the normal U.S. tax deductible insurance reserve amounts ceded to the affiliated reinsurer should be deductible in arriving at “adjusted taxable income” of the ceding company before applying a percentage limitation. These expenses would have been immediately tax deductible to the domestic ceding company if it had kept the business.

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