WASHINGTON ADVOCATES GROUP

Reagan International Trade Center, Suite 700
1300 Pennsylvania Avenue, N.W.
Washington, D.C. 20004

Brenda R. Viehe-Naess
Attorney-at-Law
Email: bvns@att.net

Phone: 202-204-3023
Cell: 202-841-3902
Fax: 202-789-7349

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VIA EMAIL

Russ Sullivan, Esq.
Democratic Staff Director
Senate Finance Committee
219 Dirksen Senate Office Building
Washington, D.C. 20510

RE: Senate Finance Committee (Majority) Discussion Draft/ Proposal to Deny Insurance Company Deductions for Affiliate Reinsurance Premiums

Dear Mr. Sullivan:

The Senate Finance Committee released a Discussion Draft of a bill that would limit the deduction for reinsurance ceded to a foreign affiliate. The Discussion Draft would permanently deny affiliate reinsurance deductions to the extent that the premium exceeded the average level of reinsurance for all U.S. property/casualty insurers, determined by line of business. The bill has been drafted in response to charges by a small group of domestic companies, led by W.R. Berkley & Co., that foreign reinsurers have a competitive advantage.

These comments on the proposal to limit deductions for affiliate reinsurance are submitted on behalf of the U.S. subsidiaries of two German insurance groups --- Allianz of America, Inc. and Munich Reinsurance America.

- Allianz SE has several U.S. insurance companies: Fireman's Fund Insurance Company, a multi-line property and casualty insurer writing personal lines, commercial lines, and specialty lines (*e.g.,* ocean marine); Allianz Global Risks US Insurance Company ("AGRUS"), a property and casualty insurer specializing in large scale commercial risks of multi-national companies; Euler Hermes ACI, a credit insurance company; and Mondial Assistance-USA, one of the nation's largest travel insurers. Together, Allianz's property-casualty insurance subsidiaries in the U.S. employ approximately 5,100 people. Worldwide, Allianz SE is one of the world's largest financial services companies.

- Munich Reinsurance America is a property/casualty reinsurance company, which has two primary insurance companies in its U.S. group. MRA's core business segments are Direct Treaty, Direct Facultative, Specialty Markets and Broker Market. The company offers a full range of property and casualty coverages, including workers compensation, auto liability, and physical damage, surety, marine, construction, errors and omissions, homeowners and commercial multi peril. In addition, Midland Insurance Group writes specialized coverages including manufactured housing, site built homes, watercraft and recreational vehicles. Sterling Insurance Group markets various products including Medicare related (Medicare Advantage and Medicare Supplement), Life and Supplemental Accident and Health policies to individuals in the U.S. over the age of 50. The combined property/casualty companies employ about 3,550 people in the U.S. The German parent, Munich Reinsurance A.G., is the world's largest reinsurer.

The two insurance groups oppose the limit on affiliate reinsurance proposed in the Discussion Draft because it would substantially increase the costs of reinsurance for their U.S. companies and thereby increase the costs of primary coverage for U.S. consumers. It would violate the commitment to non-discrimination and the arm's length principle in the U.S.-German tax treaty, and result in double taxation of reinsurance premiums at a confiscatory rate. Contrary to assertions by the domestic group supporting the proposal, the proposal does not create a "level playing field," but places foreign owned companies at a severe competitive disadvantage.

International Reinsurance Benefits U.S. Consumers

The U.S. insurance market, the world's largest, depends upon capacity provided by both foreign and domestic reinsurers to provide coverage to U.S. individuals and businesses at affordable rates. International reinsurance has allowed domestic companies to write coverage in high risk areas, subject to hurricanes and earthquakes, as well as to cover risks where losses can be substantial (medical malpractice, product liability) or even catastrophic, such as the World Trade Center losses or coastal hurricanes. For example, MRA covered \$1.32 billion of losses for the World Trade Center event in 2001, of which the German parent provided \$758 million (or 54%) as reinsurance coverage. MRA also covered \$649 million for Hurricane Katrina, and \$81 million for Hurricane Francis, for which the German parent also provided substantial reinsurance coverage.

If the Discussion Draft were enacted, it would result in the loss of a substantial portion of the reinsurance deduction for U.S. subsidiaries of foreign insurers. These subsidiaries would be required to pay higher taxes, and ultimately would respond by reducing coverage or raising prices to compensate for the higher tax costs. In short, if the proposal were adopted, coverage would only be available to U.S. consumers at substantially higher rates, and in some lines and certain high risk locations, might become unavailable altogether.

A tax measure restricting the flow of international reinsurance would have an important macroeconomic effect as well: when the U.S. has been struck by catastrophic events, foreign reinsurance has played an important role in reducing the impact of the losses on the U.S. economy. Not only are U.S. consumers reimbursed promptly for their losses, but a major portion of the overall economic loss is shifted outside the U.S. economy, so that the American economy can recover more rapidly. If tax barriers to international reinsurance are created, catastrophic losses are more likely to remain within the U.S. economy, further delaying recovery.

AFFILIATE REINSURANCE IS PURCHASED FOR SOUND RISK MANAGEMENT REASONS, NOT TAX AVOIDANCE

Reinsurance is a key tool for management of risk by insurance companies. Domestic and foreign companies rely upon reinsurance to prevent insolvency and to some extent, to reduce the volatility of property/casualty insurance. For a rapidly growing company, reinsurance provides additional capital that enables the company to accept new business. Affiliate reinsurance also allows a parent company to pool similar business from different geographic areas, in order to manage claims and investments efficiently, track experience by line, and take advantage of the expertise of specialized underwriters and claims managers.

Large multi-national insurers seek to centralize capital in a single location, so that the foreign parent can manage investments efficiently, reduce the cost of capital, and respond promptly to claims from a subsidiary. This enables a foreign reinsurer to use its capital to cover windstorm damage in Europe one year, earthquake claims in South America another, and hurricane losses in the U.S. the next.

Affiliate reinsurance is employed by domestic companies as well as foreign companies. U.S. companies in the Berkley Group and other members of the domestic coalition supporting the limits on affiliate reinsurance employ high levels of affiliate reinsurance, thereby demonstrating the importance of efficient capital management and pooling of risks to *all* types of insurers --- both domestic and foreign.

When assigning a rating to the U.S. subsidiary of a foreign company, rating agencies consider affiliate reinsurance as a favorable indicator of the importance of the U.S. subsidiary to the group. A strong rating is important for primary insurers, and critical for reinsurers, since many companies instruct brokers to solicit bids only from reinsurers with a strong rating. On occasion, rating agencies have made it clear that additional support from the foreign parent, in the form of reinsurance, a capital infusion, or a pooling arrangement, is essential to maintain a rating. A tax measure which effectively penalizes a U.S. company from entering into affiliate reinsurance agreements designed to preserve a strong rating would be disastrous.

DISCUSSION DRAFT PLACES FOREIGN OWNED FIRMS AT A SUBSTANTIAL COMPETITIVE DISADVANTAGE

The Press Release accompanying the Discussion Draft states that the proposal is intended to "address the concerns that current law does not adequately level the playing field between domestic and foreign related party reinsurance." According to the Press Release,

> "foreign insurance companies may have a competitive advantage over U.S. firms because they can use related party reinsurance to reduce their tax liabilities on investment income… when a U.S. subsidiary writes the initial insurance policy and then reinsures the policy to its foreign parent corporation, or 'related party,' that is located in a low or no-tax jurisdiction such as Bermuda or Switzerland."

The statement assumes that all foreign parents are located in a low tax or no tax jurisdiction, and that the foreign parent does not pay tax on the premium or investment income associated with the reinsurance. The assumption is simply inaccurate. The proposal fails to recognize that insurers use affiliate reinsurance for prudent risk management reasons, rather than tax avoidance. It is based upon flawed assumptions about the functions and patterns of reinsurance of large multi-national insurers.

In reality, many foreign jurisdictions impose substantial taxes upon their insurers. German insurers are subject to taxes at a combined rate of nearly 33 per cent[1] on both premium and investment income of reinsurance transferred from the U.S. subsidiaries. The U.S.- German tax treaty, in effect, recognizes that the German corporate tax is substantial and reduces the U.S. 30 percent withholding tax rate to 15 per cent on unaffiliated dividends and zero for qualifying intercompany dividends, and, more to the point, waives the federal excise tax on insurance premiums. The rationale offered by the Press Release for the proposed denial of affiliate reinsurance deductions does not apply to reinsurance ceded to German affiliates.

Worse yet, the denial of the deduction subjects reinsurance premiums to double taxation, first by the U.S., and then by Germany. The end result is that taxes upon reinsurance ceded to a German affiliate would be more than doubled --- a substantially higher cost than if reinsurance had not been ceded to the parent at all.

An analysis of the proposal demonstrates that its impact is extremely harsh. It would deny a deduction for reinsurance in excess of the industry average, which is based upon average reinsurance with *unaffiliated* companies --- a very different market, and not an appropriate measurement. Moreover, the use of stale data --- two year old industry averages --- means that the cap does not reflect changes year-to-year in the financial environment or individual company loss patterns. Thus, U.S. subsidiaries of foreign companies could be operating within industry averages for a given year but would be penalized financially and competitively because of the application of an outdated standard. In fairness, the U.S. insurer owned by a foreign parent should have the same flexibility to change its reinsurance patterns in response to changes in the financial environment or in claims patterns as a domestic company.

If industry averages for 2007 were used, the proposal would result in substantial disallowance of reinsurance deductions for lines of business where reinsurance makes the most sense --- lines covering multinational businesses and volatile lines with low frequency/high severity claims patterns, where the risk is characteristically transferred to protect the stability of the U.S. subsidiary and enable the parent to pool similar risks from different locations. For example, the 2007 industry average for the aircraft line was 30.0%, even though within the 1995 – 2007 period it had averaged as high as 58.4%. Similarly, ocean marine reinsurance deductions would have been disallowed if it exceeded 21.2%, and the deduction for earthquake was limited to 29.5%. A major reinsurer would be limited to a deduction of 2.0% for non-proportional

[1] German corporations are subject to a corporate income tax at the rate of 15%, plus a solidarity surcharge of 0.825%, plus a trade tax that varies by municipality. In Munich (headquarters of both Allianz and Munich Reinsurance), the trade tax is 17.15%. The combined rate in Munich is 32.98%.

assumed liability, since the industry average is based upon the reinsurance practices of a large number of small companies that write little or no non-proportional coverage and do not need to reinsure significant amounts to protect against volatility and insolvency. In short, an industry average is not a reliable indicator of normative patterns of reinsurance.

The proposal's underlying assumption is that reinsurance of a line of business in excess of an "industry average" clearly demonstrates that affiliate reinsurance is undertaken for tax avoidance purposes. In reality, reinsurance patterns vary according to the line of business and the company's business model. An industry average is not a fair or reasonable measure of appropriate levels of reinsurance --- much less an indication of tax avoidance. The attempt to impose such an arbitrary limit should be abandoned.

CURRENT LAW HAS ADEQUATE TOOLS TO DEAL WITH INCOME SHIFTING

The proponents of the limitation have charged that affiliate reinsurance has led to income shifting. Although they have presented no evidence to support this charge, it is important to note that the IRS has substantial tools at hand to deal with any abuse. The transfer pricing rules of Section 482 allow the IRS to "distribute, apportion, or allocate gross income, deductions, credits or allowances between or among [related parties] if [the Commissioner] determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income" of the related parties. Under Section 6038A of the Code, every foreign controlled corporation is required to maintain contemporaneous records of transactions with its foreign parents, which effectively serve as "road maps" for international examiners during an audit.

In addition, there are special rules governing related party reinsurance, which function in a manner roughly similar to the transfer pricing rules. Section 845(a) provides that the Commissioner may reallocate

> "income (whether investment income, premium, or otherwise) deductions, assets, reserves, credits or other items" related to reinsurance agreements between related parties, or "recharacterize such items, or make any other adjustment if it determines that such reallocation is necessary to reflect the proper *amount*, source or character of the taxable income (emphasis added)"

The authority to reallocate the "amount" was added in 2004, expressly to address concerns raised by members of the domestic group in an earlier campaign. The IRS already has sweeping authority to address income shifting through reinsurance. No new or specially tailored rule is needed for reinsurance.

THE PROPOSAL WOULD VIOLATE THE U.S.-GERMAN TAX TREATY

The proposal would violate the US.- German Tax Treaty in several respects: (1) it would depart from the commitment to the arm's length method of determining income of related parties in Art. 9; (2) it would violate the non-discrimination provisions of Art. 24; and (3) it would result in double taxation of reinsurance premiums by both the U.S. and Germany.

(1) Arm's Length Method

Article 9 of the U.S.- German Tax Treaty provides that either state may reallocate profits of an enterprise within its jurisdiction where it finds that an agreement between two related parties creates terms that are different from those that would have been set by independent parties. The Treasury Department's Technical Explanation[2] of the treaty states,

> "This Article incorporates into the Convention the general principles of section 482 of the Code. It provides that when related persons engage in transactions that are not at arm's length, the Contracting States may make appropriate adjustments to the taxable income and tax liability of such related persons to reflect what the income or tax of these persons with respect to such transactions would have been had there been an arm's-length relationship between the persons."

The U.S. Government's long-standing commitment to the arm's length standard has been clearly reiterated in the Treaty. The proposal's blanket denial of affiliate reinsurance deductions above an industry average would be inconsistent with the commitment to the arm's length standard in the Treaty, since it would disallow all reinsurance deductions, without regard to whether the premiums are appropriate under transfer pricing methodology. The proposal represents a significant departure from long-standing U.S. tax policy supporting the arm's length standard.

In the Joint Committee *Analysis*[3] prepared in connection with the Senate Finance Committee hearing on September 26, 2007, the assertion was made that a limitation on reinsurance deductions could be imposed without violating U.S. tax treaties. The assertion is not credible. In a court review of a comparable attempt to impose a tax on imputed minimum investment income, the Tax Court held that the use of an industry average was a violation of the U.S.-Canada Tax Treaty. *North West Life Assurance Co. v. Commissioner,* 107 T.C. 363 (1996). The Tax Court held that Section 842's use of an industry average to determine the minimum investment income of the U.S. branch of a Canadian life insurance company was a violation of the separate entity principle in the Treaty. The Court noted in that case, that "our goal is to construe the Convention according to the "genuine shared expectations of the contracting parties," *Maximov v. United States,* 299 F.2d 565, 568 (2d Cir. 1962), aff'd, 373 U.S. 49 (1963)). In view of the strong commitment made to the arm's length principle in the U.S.-German Treaty,

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[2] *Treasury Department Technical Explanation of the Convention and Protocol between the United States and the Federal Republic of Germany,* June 14, 1990.

[3] *Present Law and Analysis Relating to Selected International Tax Issues,* Prepared by the Staff of the Joint Committee on Taxation for a public hearing before the Senate Finance Committee on September 26, 2007, JCX-85-07.

the abandonment of that principle solely with respect to affiliate reinsurance premiums is likely to be viewed as a violation of the German Treaty.

(2) Non-Discrimination Provisions

Art. 24, Par. 3 of the Treaty provides that "disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State 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." The Technical Explanation states simply, "Paragraph 3 prohibits discrimination in the allowance of deductions." The Technical Explanation recognizes that a deduction may be altered if a transfer pricing examination determines that the amount is excessive. No other limitations on deductions, other than transfer pricing, are recognized as exceptions to the non-discrimination requirement.

In addition, Art. 24, Par. 4 expressly guarantees equal treatment for subsidiaries of a treaty partner corporation:

> "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 proposal would subject US. subsidiaries of foreign companies to a limitation that is not applied to U.S. companies --- affiliate reinsurance could only be deducted to the extent it falls below the industry average. Yet U.S. insurers reinsure substantial amounts with affiliates without any limitation. The denial of such an important deduction is a clear violation of the German treaty's non-discrimination article.

(3) Double Taxation of Income

Avoidance of double taxation of income is the fundamental purpose of entering into a tax treaty. Yet denial of affiliate reinsurance deductions would result in double taxation of reinsurance premiums ceded by a U.S. subsidiary to its German parent, first by the U.S. and then by Germany. The combined tax rates would exceed fifty per cent of the premium, a striking illustration of the harsh effect of the proposal. Unquestionably, the proposal would also result in a dramatic increase in the cost of reinsurance or a decrease in its availability.

THE PROPOSAL IS A PROTECTIONIST MEASURE THAT WOULD INCREASE PREMIUMS FOR U.S. CONSUMERS

The permanent denial of affiliate reinsurance deductions would change important and well established reinsurance practices. Typically, U.S. subsidiaries of foreign insurers would be forced to limit available capacity or increase premiums. Either alternative would result in higher prices for U.S. consumers. Clearly, the undisclosed goals of the domestic coalition are to set up protectionist tax barriers to international reinsurance, and to allow them to benefit from reduced price competition. We urge the Committee to reject this proposal, and to allow international insurers to continue to provide U.S. consumers coverage at affordable rates.

Sincerely,

Brenda Viehe-Naess

cc: Cathy Koch, Senate Finance Committee
Joshua Odintz, Senate Finance Committee
Mark Prater, Senate Finance Committee
Ed Kleinbard, Joint Committee on Taxation