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TO: The International Tax Working Group of the Senate Finance Committee

RE: Modernization of Rules Governing Insurance Income under the Active Finance Exception

These comments are filed by the Reinsurance Association of America, the leading trade association of property and casualty reinsurers doing business in the United States. The RAA is committed to promoting a regulatory environment that ensures the industry remains globally competitive and financially robust. RAA membership includes U.S. reinsurance companies that write reinsurance through foreign subsidiaries and branches, and which are subject to the current rules governing insurance income in Subpart F of the Code.

RAA welcomes the opportunity to comment on changes needed to modernize the current international tax rules. Our comments address issues which are unique to the insurance industry which your Committee needs to take into consideration as you explore ways to modernize the taxation of international operations of U.S. based companies. While the comments focus on reinsurance companies in particular, the rules apply to both reinsurance and primary insurance companies and branches, both property and casualty (P&C) and life, and the term “insurance” in these comments covers all types of insurance and reinsurance income.

Insurance company income consists of premium income and investment income, which comprise the source of funds used to pay policyholder obligations. Investment income is an integral part of the insurance business, and is used in the active conduct of the insurance business; it has long been recognized as an integral part of insurance operations under Subpart F’s Active Finance Exception (AFE) and granted deferral along with underwriting income.

Current law provides only a limited exception for investment income of a foreign insurance subsidiary. Under Subpart F, a foreign insurer’s investment income would be treated as currently taxable in the year in which it is earned, but for the adoption of the AFE allowing the deferral of investment income meeting certain highly restrictive requirements. These requirements, adopted in 1998, are, in many respects, no longer consistent with typical insurance company operations in international markets. While they form an impediment for many foreign insurance subsidiaries, the burden upon reinsurance subsidiaries is particularly acute. The unfortunate result is that reinsurance subsidiaries of an American insurer bear a higher tax burden than their local competitors and are placed at a competitive disadvantage. These outdated requirements should be revised to promote U.S. reinsurers’ growth and competitiveness in foreign markets.

In addition, the AFE was adopted on a temporary basis, and has been subject to renewal repeatedly since 1998. If tax reform is to produce any simplification of current law --- and U.S. companies are to be able to structure operations for a long term --- the reforms to rules governing insurance subsidiaries must be made permanent.

ANALYSIS

A. The Reinsurance Company Business Model

Reinsurance is the mechanism by which insurance companies manage their risk. Insurance companies purchase reinsurance for four primary reasons: (1) to limit liability on specific risks, (2) to stabilize loss experience, (3) to protect against catastrophes, and (4) to increase capacity. The fundamental objective of insurance, to spread the risk so that no single entity finds itself saddled with a financial burden beyond its ability to pay, is enhanced by reinsurance.

Reinsurance is a global business, with U.S. companies covering foreign risks through local reinsurance companies and foreign companies writing U.S. coverage through U.S. subsidiaries --- all structures contributing to the diversification of risk.

Reinsurers are the financial intermediaries for the insurance business, and enhance their clients' solvency, since a number of foreign countries do not provide Federal or State based insurance funds that back the risks underwritten by their insurance companies. Reinsurers accept risks from a number of companies, typically diversified by type of risk and geographic region, and pool these risks to arrive at a manageable risk profile for the reinsurer. Like primary insurers, reinsurers also purchase reinsurance, called "retrocessions."

To meet their expected liability, reinsurers hold large amounts of capital beyond their immediate needs for claims reserves. In fact, there has been a notable trend in recent markets toward selection of the very largest companies for reinsurance placements, with an accompanying trend toward consolidation of small and mid-sized companies in order to compete in the industry.

A significant characteristic of the reinsurance business model is the need to manage capital efficiently. The reinsurance market is highly competitive, and efficient capital management is critical to maintaining competitive premium levels. Regulators require significant amounts of capital or "surplus" to meet catastrophic risks that may occur infrequently, based upon regulatory models. Credit rating agencies determine the strength of the reinsurer based, in part, on its capital beyond regulatory minimums. As a practical matter, the credit rating agencies' views of a reinsurer's strength play a major role in determining its competitiveness.

Reinsurance groups typically write through large corporate groups, with individual companies or branches established in a multitude of foreign regulatory jurisdictions. In many cases, the local companies or branches transfer significant portions of their risk portfolio to a regional or global reinsurance affiliate. This structure allows the corporate group to pool risks and diversify its global exposures, to achieve the most efficient use of its capital, and to purchase reinsurance for the group in a more cost effective way than if each subsidiary or branch purchased reinsurance separately.

B. Changes Needed to Enhance the Competitiveness of Reinsurance CFCs

Previous proposals for international tax reform from both the tax writing committees, individuals, and coalitions have included several common themes: the need to reduce or eliminate high levels of U.S. taxation on foreign earnings, protection against base erosion, consideration of a minimum tax on foreign earnings when earned or repatriated, and recognition that financial services companies' investments represent an integral part of their operations and may require special treatment. In many proposals, it is assumed that Subpart F rules will be preserved in some fashion to distinguish between income that may be subject to immediate taxation and income that is deferred.

Changes are needed to several provisions of the current international tax rules governing insurance income of Controlled Foreign Corporations (CFCs), so that U.S. companies' foreign insurance subsidiaries may compete more effectively in international markets. In many cases, it is impossible for foreign insurance subsidiaries to satisfy current Subpart F rules for deferral of investment income. As a result, U.S. taxes are imposed in addition to foreign taxes, and foreign reinsurance subsidiaries are placed at a competitive disadvantage. Examples of anti-competitive restrictions and recommendations for change are given below.

1. Definitions of an Insurance Company/ Exempt Contract

The current Subpart F rules create obstacles to qualification of "insurance income" and its corollary "qualified insurance company" status by reinsurance subsidiaries operating abroad. Under Code §953(e)(3), an insurance company is defined as one that is subject to regulation as an insurance company by its home country, is licensed or regulated as an insurance company by its home country, and is engaged in the insurance business and would be subject to tax under Subchapter L if it were a U.S. company. Similarly, a foreign insurance CFC operating through branch form in other foreign countries must also deal with meeting the definition of a qualifying insurance company branch under Code §953(e)(4). These rules were written over 25 years ago when few foreign countries had rigorous local insurance regulatory structures. However, over this time period the level of regulatory supervisions around the world has increased substantially such that U.S. based insurance companies operating in foreign locations must deal with a myriad of different regulatory requirements which generally impose financial restrictions in the local country similar to those imposed by insurance regulators in the U.S.

In addition to the requirements under Code §953(e), Subpart F imposes minimum home country requirements, substantial business activity requirements, and, in effect, a disallowance of related party income. We question whether there is a clear policy rationale for these additional requirements in the highly regulated and competitive international insurance market.

Related Party Income: Under Section 953(e), a foreign insurer may not count related party income as qualifying insurance income and a foreign subsidiary or branch may not count related party income toward its requirements for qualification. This requirement is incompatible with reinsurance company "best practices," since it penalizes foreign reinsurance groups for pooling their global risks and thwarts efficient capital management. For example, under the EU Reinsurance Directive which became effective in 2007[1], a reinsurer headquartered in the

[1] http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1428694890393&uri=CELEX:32005L0068

European Union may write business in all EU member states without setting up a subsidiary or branch in the other member states. This process is commonly referred to as the use of a "single passport" to write coverage within all EU countries. The EU regulatory authority of the reinsurer's domicle in the EU is responsible for regulating the activities of the reinsurer within the other EU member states. While the EU passport structure is an efficient means for writing reinsurance within the EU, this structure does not align well with the outdated definitions in Code §953(e).

To minimize costs for operating outside of the EU, reinsurers establish local companies or branches in local jurisdictions to write new business, but centralize underwriting, actuarial, and investment functions in regional hubs or at the headquarters. Many times, the subsidiaries transfer a significant portion of their risks to the headquarters in order to achieve a pooling of global risks. Under the related party rules of Code §953(c)(2), the headquarters company cannot count these "related party" risks toward the company's QIC status or toward the "exempt contract" requirement --- thereby jeopardizing the headquarters' ability to treat investment income as insurance income and obtain partial deferral under Subpart F.

> *At a minimum, the Code should recognize that reinsurance from members of an insurance group is not a "related party" risk if the reinsurance contract covers risks from other independent sources. A better approach would be to eliminate the prohibition on related party reinsurance all together.*

<u>Home Country Requirement</u>: Similarly, the home country requirements in the definitions of exempt insurance income and qualifying insurance company are inconsistent with the global nature of the reinsurance business. The law of large numbers provides that an insurer is better able to project the losses on a pool of business as the pool increases in size. Reinsurers gain greater stability by diversifying risk among geographic regions and lines of business. Yet the requirement of home country content of 30% for an exempt contract and 50% for a qualifying insurance company means that the headquarters and many of its operating subsidiaries or branches will fail the tests for exclusion of investment income under Subpart F or its successors.

> *A better approach would be to eliminate the home country requirements completely. If this cannot be done for all insurance companies, rules governing reinsurance companies and groups should recognize the need to consolidate reinsurance risk. Tax rules should not handicap reinsurers competing in foreign markets.*

<u>Requirements for a QIC</u>: At this point, policymakers may ask what would separate a true commercial insurance or reinsurance company from a foreign investment vehicle inappropriately seeking to claim insurance company status to reduce or eliminate U.S. taxation. We submit that the tests already incorporated in the Code are adequate to distinguish a true commercial insurer from an investment vehicle. Under Code §953(e)(3), an insurance company is defined as one that is subject to regulation as an insurance company by its home country, is licensed or regulated as an insurance company by its home country, and is engaged in the insurance business and would be subject to tax under Subchapter L if it were a U.S. company. The IRS has developed ample criteria to identify a valid insurance company. For example, in Rev. Proc. 2003-34, the IRS warned investors that a foreign company would not qualify for the insurance company exception to the passive foreign investment company (PFIC) rules unless:

- The company wrote true insurance contracts which involved both risk shifting and risk distribution;
- The company's primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies;
- The company "must use its capital and efforts primarily in earning income from the issuance of contracts of insurance," based upon an examination of the size and activity of its staff, whether it engages in other activities, and its sources of income; and
- The character of all the business actually done, including whether there is a noticeable disproportion between investment and insurance income.

In recent discussions of this issue with Finance Committee staff and Treasury, RAA has proposed the creation of a "safe harbor" or rebuttable presumption to identify a valid foreign insurance company, accompanied by a ruling process which would allow a company that fails the safe harbor tests to demonstrate that it is, nonetheless, engaged in the active conduct of an insurance business. Among the factors to be considered for a company that did not meet the safe harbor were the types of business written, whether the company is in runoff or start-up mode, and, significantly, the existence of a credit rating necessary for the insurer to write local business. There are already long established criteria to distinguish an insurance company from a mere shell.

<u>"Business Activity" Test</u>: Although the 1998 rules made a modest attempt to allow income funding cross-border risks to be deferred as exempt insurance income, Code §953(e)(2)(A)'s requirement that the QIC must conduct "substantial business activity" within its home country also presents a hurdle for groups organized using branches or local subsidiaries which rely upon the services performed by headquarters. While this test has not been defined in Subpart F regulations, the inversion regulations (Treas. Reg. §1.7874-3T) define "substantial business activities" as having 25% of employees, assets, and gross income in the foreign acquirer's country of organization, and these have been regarded as representative of the IRS's view on this requirement. Imposing such requirements on an insurance group would be inappropriate. While the headquarters might satisfy a 25% test, it is doubtful that all local operating companies could.

We appreciate the importance of drawing lines between a true commercial insurance company and an investment vehicle inappropriately claiming the insurance company exception to the PFIC rules. In developed and emerging countries today, there are rigorous insurance regulatory rules in place which place a variety of requirements on foreign insurance companies doing business in these locations. In its submissions to the Finance Committee, RAA has proposed using a qualitative standard that mirrors the tests in code §953(e)(3). We believe the tests outlined in Code §953(e)(3) and Rev. Proc. 2003-34 encompass a broad range of case law and administrative guidance that clearly distinguish a true insurance company from an investment company. A better approach would be to designate the "substantial business activity" test as a factor in determining whether the company is engaged in the active conduct of an insurance business, to be considered along with other factors when determining whether a company qualifies for insurance company treatment under Code §953(e)(3).

2. Treatment of Investment Income From Required Capital

Code §954(i) excludes a QIC's investment income from foreign personal holding company income currently taxable under Subpart F. Code §954(i)(2) limits the amount of investment income excluded to 1/3 of premiums earned on P&C and health insurance, and 10% of reserves for life and annuity contracts. As noted above, the global regulatory landscape for insurance companies has changed dramatically from the 1980's. Regulators throughout the world have adopted risk based capital rules, which impose higher capital requirements than the stated minimums. For example, European Solvency II requirements impose upon all members of a group --- both within the EU and outside it --- minimum capital requirements tailored to the type of risk they have assumed. These regulatory measures bear no relationship to the 1980's standard of 1/3 of premiums for P&C companies or 10% of reserves for life insurance companies, so that reinsurance CFC's are likely to be taxed on income necessary to satisfy local regulatory requirements --- and unavailable for repatriation to the U.S. parent.

A more modern standard would allow the exclusion of the full amount of investment income attributable to investments held to meet regulatory requirements. The artificial percentage limitations should be eliminated. The IRS or the Treasury Department's Federal Insurance Office should publish a list of countries with qualifying regulatory regimes within one year of the Act's effective date and update it annually.

3. Recalculation of Foreign Insurance Reserves

The calculation of insurance income and the excluded investment income for a P&C insurer in part requires a recomputation of the foreign reserves using U.S. tax rules for reserves under Subchapter L of the Code. For P&C insurers, this principally involves the application of discounting such reserves using the foreign loss payment pattern and the U.S. mid-term AFIR --- a tedious and expensive process. While life insurance companies may use foreign reserves with the permission of the Commissioner rather than recompute their foreign reserves under Code §807, a ruling must be obtained for each foreign company --- again, a slow and costly process.

Because foreign reserves are a critical element in determining the foreign company's net income and, in turn, the amount eligible to be paid as a dividend to its U.S. parent, the rationale for imposing an artificial measure (U.S. reserve calculations) to determine foreign net income seems indefensible. In the real world, a foreign subsidiary can only send dividends to its parent as permitted by local regulators, using local reserve calculations. The current tax law is out of sync. It taxes amounts that cannot be repatriated, and puts foreign subsidiaries at a competitive disadvantage.

In short, current tax law imposes a significant burden on the foreign insurance operations of U.S. based insurance companies who must conform their reserves to U.S. regulatory standards. However, with the development of significant regulatory regimes in most developed and emerging market countries around the world, the need for these burdensome changes to reserves should be reconsidered.

A better approach would be to allow the use of foreign reserves in countries having a well developed regulatory regime, such as the EU, without the need for obtaining a ruling for each subsidiary. This change would prevent foreign insurance companies from *paying tax on amounts that cannot be repatriated. The IRS or the Treasury Department's Federal Insurance Office should publish a list of countries with qualifying regulatory regimes within one year of the Act's effective date and update it annually.*

4. Tax on Accumulated Foreign Earnings

Several proposals have included a one-time tax on foreign earnings accumulated in prior years, but untaxed under existing tax rules. Tax rates ran as high as 14% in the FY 2016 Administration Budget proposal.

If such a tax is included in a Finance Committee draft, RAA recommends that it exclude income which cannot be repatriated because of local regulatory requirements in the subsidiary's home country.

5. Minimum Tax on Deemed Repatriated Foreign Earnings

Various proposals have included a minimum U.S. tax on deemed repatriated foreign earnings for all future years, which have run as high as 19% in the FY 2016 Administration Budget.

If a minimum tax is applied to all future earnings, it is important to preserve the exclusion for insurance company investment and underwriting income that cannot be dividended up to the U.S. parent because of local regulatory restrictions.

6. Insurance Income Should Be Taxed Only Under Insurance Tax Provisions

In the Camp bill (H.R. 1), a minimum tax was imposed at the rate of 12.5% on low-taxed AFE income. Some part of exempt insurance income could fall under the definition of "Foreign Base Company Intangible Income" which would be taxed under this alternate regime. This makes no sense.

The insurance industry needs provisions tailored to its operations to protect against excessive taxation that would render it impossible for insurers to compete in foreign markets. The multiple layers of taxation imposed upon insurance income under the Camp bill should be avoided.

SUMMARY

The rules governing taxation of foreign insurance income are outdated and incompatible with industry practices. They create an impediment to foreign insurance subsidiaries' competition in international markets, and should be revised to promote growth and competitiveness.

More appropriate rules would recognize the need for adequate capital not only to fund reserves but also to satisfy regulatory requirements for risk based capital. Modern rules should recognize that pooling risks from many geographic locations is a core business practice for reinsurance companies. Current rules that impose additional taxes on reinsurers following this essential risk management function should be eliminated. In determining the amount of excluded investment income, modern rules should remove the onerous requirement of recalculating foreign reserves according to U.S. tax rules, and allow the use of local reserves in countries with a well developed regulatory regime.

RAA appreciates the importance of providing a tax code that promotes growth in foreign markets and recognizes contemporary international insurance practices. RAA member companies would welcome the opportunity to discuss these proposed improvements to current law with you. You may contact Joseph Sieverling (Sieverling@reinsurance.org or 202-783-8312) or Brenda Viehe-Naess (bvns@att.net or 202-735-0060) if you have questions or comments.