PRESENT LAW AND ANALYSIS RELATING TO THE TAX TREATMENT OF REINSURANCE TRANSACTIONS BETWEEN AFFILIATED ENTITIES

Scheduled for a Public Hearing
Before the
SUBCOMMITTEE ON SELECT REVENUE MEASURES
of the
HOUSE COMMITTEE ON WAYS AND MEANS
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INTRODUCTION AND SUMMARY

The Select Revenue Measures Subcommittee of the House Ways and Means Committee has scheduled a public hearing on tax issues relating to reinsurance transactions between affiliated entities on July 14, 2010. This document,[1] prepared by the staff of the Joint Committee on Taxation, includes a description of present law and analysis of Federal tax issues relating to reinsurance transactions involving foreign affiliates.

Part One of this document provides background information about offshore reinsurance. Part Two provides economic data on insurance and reinsurance. Part Three describes present law relating to Federal income tax treatment of insurance companies, the excise tax applicable to premiums paid to foreign insurers and reinsurers covering U.S. risks, and applicable international tax rules under U.S. Federal tax law and international tax treaties. Part Four provides a description of legislative proposals in recent Congresses relating to offshore reinsurance. Part Five provides a discussion of issues and analysis relating to offshore reinsurance. Unless otherwise noted, section references are to the Internal Revenue Code of 1986, as amended (the "Code").

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[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Analysis Relating to the Tax Treatment of Reinsurance Transactions Between Affiliated Entities* (JCX-35-10), July 12, 2010. This document is available on the internet at www.jct.gov/.

I. BACKGROUND

Offshore reinsurance

Insurance company reinsurance transactions with offshore reinsurers, particularly affiliated offshore reinsurers, have been characterized as creating the potential for tax avoidance and as causing a competitive disadvantage for U.S. insurance businesses. At the same time, reinsurance is a fundamental component of global risk management techniques.

Insurance and reinsurance in general

Insurance is a mechanism for transferring the financial consequences associated with the occurrence of identifiable but uncertain adverse events. For example, insurance may serve to transfer the risk of damaging one's automobile in an accident, the risk of fire damaging one's home, or the risk of dying prematurely.

Insurance transactions are characterized by risk shifting and risk distribution.[2] Risk shifting means transferring the risk from one person to another person. Risk distribution means spreading risks among a pool or group of persons.

The concept of risk shifting contemplates that the insured shifts to another person the financial consequences of the uncertain adverse event, so that the occurrence of the event has no direct financial impact on the insured to the extent of the insurance. Thus, self-insurance generally is not insurance in this sense, because the self-insured person retains the financial consequences that follow from the occurrence of the adverse event.

Risk distribution refers to the fact that, in entering into any one line of the insurance business (such as automobile liability insurance or health insurance), insurers assume or underwrite numerous individual risks that are typically independent but homogeneous. Risks are independent when the occurrence of one adverse event in the pool of risks held by the insurer provides no information about the likelihood that the other adverse events in the pool will occur. Risks are homogeneous when they are similar in nature.

Insurers generally price the premiums that are to be paid by policyholders so as to reflect the total losses expected from each pool of insured risks in each period. For example, when an individual buys automobile collision insurance, he shifts from himself to the insurer the risk of paying for damages sustained by his automobile as a result of an accident. The insurer in turn manages that risk by pooling it with other similar automobile insurance contracts that it writes. In this way, each customer (through the premiums paid) effectively pays for a portion of the damages sustained by all the automobiles in the pool. Because most people are risk averse, they prefer to suffer definite but small losses (the premiums they pay) rather than unpredictable but much larger losses (the financial consequences of a loss event if one were self-insured).

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[2] In *Helvering v. LeGierse*, 312 U.S. 531 (1941), the Supreme Court, interpreting tax statutory language, established that the elements of risk shifting and risk distribution are essential to insurance (in that case, life insurance).

Insurance covers a variety of types of risks, which are grouped by line of business under current industry practice and regulatory reporting rules. Some lines of business tend to be paid out relatively promptly following the time when the risk is incurred, such as health insurance and automobile liability; these are known as short-tail lines of business. Other lines of business are characterized by longer payout periods, such as medical malpractice and workers compensation; these are known as long-tail lines of business. During the first years following the year of coverage, long-tail lines of business tend to have a relatively high proportion of unpaid losses, including losses that are incurred but not reported during the year, whether due to nonobservance of the event of loss, nonreporting of the claim, litigation, or other reasons.

Insurance companies are regulated by State insurance regulators in the States in which they do business. State regulators look to the National Association of Insurance Commissioners (the "NAIC") for recommendations on regulatory and reporting standards. State insurance rules require annual financial reporting by insurers in accordance with a specific accounting method known as "statutory accounting," which is designed to maintain insurer solvency.

Types of reinsurance

Reinsurance is a form of further risk shifting and risk distribution. Reinsurance is sometimes characterized as insurance for insurers. A reinsurance transaction is an agreement between insurance companies to pass -- or cede -- a risk, or a block of risks, from one company to the other company. The insurance company that passes the risk to the reinsurer is sometimes referred to as the ceding company, and the reinsurer that takes on the risk is sometimes described as assuming or indemnifying the risk.

Risks can be subdivided and portions reinsured. For example, a portion of the risk may consist of a specific dollar amount such as a layer or band of the total dollar amount, the excess over a dollar amount, or a percentage of the total dollar amount of the risk.

Risks can be reinsured singly or in groups. "Facultative" reinsurance covers a specific risk and is separately negotiated, often because the risk is specialized, high-hazard, or extraordinarily large. For example, facultative reinsurance might cover some or all of the risk associated with a specific piece of high-value jewelry, or a building in a location with particular hazards. A reinsurance "treaty" generally covers a block of risks or type of risks. Under a reinsurance treaty, the primary insurer and the reinsurer agree that all or a specified portion of the primary insurer's business or policies of a particular type or types are covered automatically by the reinsurer until the agreement is terminated.

The portion of a risk covered under a reinsurance agreement can be determined in a variety of ways. Proportional, or pro rata, reinsurance can be on a "quota share" basis, that is, a set percentage of premiums received and losses covered for the applicable risks. Alternatively, proportional reinsurance can be on a "surplus share" basis, that is, an agreed dollar amount of premiums received and losses covered for the applicable risks. Non-proportional reinsurance is known as "excess of loss," representing the reinsurer's coverage for losses above the primary insurer's retention amount. Excess of loss coverage can be on an individual risk basis, on an occurrence basis (relating to the occurrence of a particular event such as a storm or earthquake), or on an aggregate basis (covering losses above a specified dollar amount per policy or per year).

Alternatives to reinsurance

A number of alternatives to reinsurance transactions may also be used to shift and distribute risks. These alternatives comprise the alternative risk transfer ("ART") markets and products. These markets and products can become more attractive when reinsurance prices rise, for example,[3] and can serve financing, hedging, or other financial purposes as well as more traditional risk management goals.

There is no generally accepted definition of what constitutes an ART product, and the ART marketplace continues rapidly to evolve. The term has been applied to arrangements as diverse as self-insurance, captive insurance, sidecar reinsurance, finite risk insurance or reinsurance, capital markets financings such as catastrophe ("cat") bonds, and weather derivative contracts.[4] Some ART products (e.g., captive insurance and finite risk insurance) typically are structured with a purpose to constitute insurance under State regulatory rules. Others, such as cat bonds, are not treated as insurance for regulatory purposes.

The characterization for Federal income tax purposes of ART products as insurance, or as some other financial product, may not be clear in all cases. Some ART products involve risk shifting, but not necessarily risk distribution. Other ART products, including many that are analyzed as insurance for regulatory purposes, raise questions of whether the product embodies sufficient risk shifting and risk distribution that it should be treated as insurance for Federal income tax purposes.[5]

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[3] The property and casualty insurance industry has historically been cyclical, involving increases and declines in prices that are known as "hardening" and "softening" insurance markets. See, e.g., Phil Gushman, "E&S Experts Say Economic Recovery Would Harden Insurance Market," *National Underwriter P&C*, March 10, 2010, www.property-casualty.com; "Rate Hardening Forces Growth in Captive Market, Aon Says," *Reactions Weekly News*, Dec. 2, 2005; "Cat Bonds Benefit from Rate Hike," *Reactions Magazine*, Feb. 2002.

[4] See Karen Eeuwens, "Convergence Quarterly: Cat Bonds to Get Q4 Boost," *Reactionsnet.com*, 27 November 2009; Peter A. Gentile, Spencer M. Gluck, Peter Senak, and Jeffrey M. Stewart, *Modern ART Practice*, Gerling Global Financial Products 2000; Thomas Holzheu, "Alternative Risk Transfer (ART) Products," in *Reinsurance: Fundamentals and New Challenges* (ed. Ruth Gastel), Insurance Information Institute (2004), 113-124; "The Picture of ART," *Sigma*, Swiss Reinsurance Company Economic Research and Consulting (2003).

[5] Two examples of the difficulties posed to the tax system by ART insurance products are finite risk insurance and captive insurance. Finite risk insurance for this purpose can be understood as a contractual arrangement whose returns predominantly reflect standard financial market terms (e.g., the time value of money), but which also embody just enough insurance underwriting risk as to be treated as insurance for at least some regulatory purposes. Captive insurance arrangements generally refer to instances in which (typically) a non-insurance company establishes an insurance subsidiary (often in Bermuda or another offshore location) to insure risks of the U.S. parent and other subsidiaries. The Internal Revenue Service ("IRS") has extensively litigated the tax status of various captive insurance or reinsurance vehicles (see cases at note 95, below). The IRS's original theory was that these arrangements did not constitute insurance in the tax sense, because the parent's ownership of the captive subsidiary meant that losses absorbed by the subsidiary ultimately were borne by the parent, as the owner of the insurance subsidiary's equity, and therefore no risk shifting occurred, and because there was no pooling of risks from outside of the affiliated group of companies. This analysis was described as the "economic family" theory. More recently, the IRS announced that, because no court had to that date wholly adopted the economic family theory, the IRS would abandon that argument, although it would continue to challenge particular arrangements that in its view did not satisfy the risk shifting or risk distribution test.

Reasons for engaging in reinsurance transactions

In general

Primary insurers have a variety of reasons for reinsuring some of their business. A principal reason is to shift risk, just as any other insured does, because an insurer's pool of risks is too concentrated in some respect.

Several related risk management and financial reporting concerns also motivate the use of reinsurance. A primary insurer can use reinsurance to reduce exposure to extremely large losses from one source such as a catastrophic event (for example, a hurricane) or a particular environmental hazard (for example, asbestos). By reinsuring amounts above a certain level, the primary insurer can smooth loss payments over the year or between years. This can reduce volatility in the company's earnings.[6]

A reinsurance transaction can function as a business acquisition technique for the reinsurer. By reinsuring a block of business, for example, a reinsurer can enter a new line of business more easily than by directly writing policies in that line of business. Similarly, a primary insurer can divest itself of a line of business by reinsuring its entire book of business in that line.[7]

Another reason for reinsurance relates to regulatory compliance. State insurance rules generally require that an insurance company maintain "surplus," and the States limit the amount of new business the company can write based on a ratio of net premiums to surplus. Reinsuring some of the company's risks can lower the ratio of net premiums[8] to surplus and allow the company to write more primary insurance. Thus, reinsurance can serve in effect as a form of financing for growth in the primary insurance company's business.

Reinsurance between affiliates

In the case of reinsurance between affiliates, there may be economies of scale in managing risk through reinsurance that may make it attractive to use reinsurance to consolidate the risks of an affiliated group in one entity, before subsequently shifting the risk to third parties or managing risk within the group. For example, risks that may partially or fully offset each

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[6] To the extent that the reinsurer's other risks are uncorrelated (or are negatively correlated) with the risk of loss that the primary insurer has ceded, the volatility of the reinsurer's losses may also be reduced by the transaction.

[7] See Donald A. McIsaac and David F. Babbel, "The World Bank Primer on Reinsurance," *Policy Research Working Paper 1512*, The World Bank (1995).

[8] The amount of net premiums for this purpose is determined net of premiums ceded to a reinsurer. Under State regulation, a ceding company treats amounts due from reinsurers as assets or reductions of liability, an accounting practice known as credit for reinsurance. Generally, reinsurers that are not licensed or authorized in a State (including foreign reinsurers) must post collateral (whether as cash, through a trust, or as a letter of credit) for credit for reinsurance to be allowed. See Joseph Sieverling and Scott Williamson, "The U.S. Reinsurance Market," in *Reinsurance: Fundamentals and New Challenges* (ed. Ruth Gastel), Insurance Information Institute (2004) at 126.

other may serve to minimize volatility when the offsetting risk pools are centralized in one entity rather than being dispersed in separate affiliated entities. Affiliated groups may also experience transaction cost savings in financing risks, for example, by issuing larger and fewer tranches of cat bonds.

Reinsurance can also serve to move capital among members an affiliated group, whether to centralize the capital for efficient management, or to shift the capital where needed to cover insured losses. For example, centralized capital may be applied to support diversified risks within the affiliated group, whether such risks are in diverse locations or are otherwise diversified. Reinsurance transactions can transfer capital in the same manner as risks are moved within the group, as capital associated with the reinsured risks is shifted among affiliates.

Federal income tax aspects of offshore affiliated reinsurance transactions

Reinsurance transactions can produce U.S. tax benefits. In general, premiums ceded by an insurer for reinsurance are deductible in determining the ceding company's Federal income tax.[9]

If the reinsurance transaction effects a transfer of assets from the ceding company to the reinsurer, the income tax liability for earnings on these assets generally is shifted to the reinsurer as well.

When these assets are shifted from a U.S. insurer to an offshore reinsurer with a foreign parent, these earnings may no longer be subject to U.S. income taxation.[10] If the U.S. insurer and the offshore reinsurer are affiliated, the profits attributable to the reinsured risks remain within the affiliated group, although the earnings on the assets may no longer be subject to U.S. income taxation.[11]

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[9] Sec. 832(b)(4).

[10] The Subpart F rules, further described below, do not apply to foreign shareholders of foreign corporations, but rather, impose U.S. income taxation on U.S. shareholders of controlled foreign corporations with specified types of income.

[11] In the case of an offshore reinsurer in a foreign jurisdiction that imposes low or no income tax, these earnings may be subject to low or no income taxation offshore.

II. DATA RELATING TO REINSURANCE

A. Insurance and Reinsurance Industry Data

For regulatory purposes, insurance companies operating in the United States report information on their financial performance on an annual statement as prescribed by the NAIC and as filed with the insurance commissioners of the States in which the companies are licensed to do business.[12] These reports include information for each of 35 lines of business on premiums written including direct business, reinsurance assumed from affiliates and nonaffiliates, reinsurance ceded to affiliates and nonaffiliates, and net premiums written.

The difference between direct business and net premiums written for all U.S. companies represents the net cessions or outflow of reinsurance offshore.[13] This flow reflects reinsurance that foreign companies assume from U.S.-domiciled companies (affiliates and nonaffiliates) net of reinsurance that U.S.-domiciled companies assume from primary insurers (affiliates and nonaffiliates) offshore.

Property and casualty insurers operating in the United States recorded $492.9 billion in directly written premiums in 2008. Assets of these insurers totaled $1.617 trillion in 2008. Such insurers ceded reinsurance of $346.5 billion to affiliates, and $67.0 billion to non-affiliates, while assuming $320.3 billion of reinsurance from affiliates and $44.4 billion from non-affiliates. Thus, net premiums written totaled $444.1 billion.[14] This is down from a peak of $453.3 billion in 2006.[15] These aggregate data for the industry indicate net cessions of reinsurance offshore by U.S. companies of $48.8 billion. It is not possible from the aggregate data to isolate the gross amount of premium ceded to offshore affiliates.[16]

Over the recent past, U.S. property and casualty insurers have increased the amount of both reinsurance assumed and reinsurance ceded, both in absolute terms and relative to direct premiums written. In 2008 the amount of assumed reinsurance, as noted above, was equal to 74.0 percent of direct premiums. Ceded reinsurance equaled 83.9 percent of direct written premiums. In 1990, by comparison, U.S. property and casualty insurers assumed reinsurance in

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[12] Aggregate industry data based on these annual statements are published by the rating agency, A.M. Best Company.

[13] This relationship is true to the extent the data represent complete coverage of U.S. insurance companies. To the extent that some firms are not included in the data, this measure may be imperfect.

[14] A.M. Best Company, "Best's Aggregates and Averages, Property/Casualty, United States and Canada," 2009 edition, at 146.

[15] *Ibid.*, at 369.

[16] The gross amount of premium ceded offshore may be determined based on individual company annual statement data. See discussion below.

amounts equal to 60.5 percent of direct written premiums, and ceded reinsurance in amounts equal to 66.0 percent of direct written premiums.[17]

While there has been growth in both assumed and ceded reinsurance, reinsurance assumed and ceded with respect to nonaffiliates has declined relative to direct premiums written. Reinsurance assumed from nonaffiliates has fallen from an amount equaling 12.2 percent of direct premiums in 1990 to an amount equal to 9.0 percent of direct premiums in 2008, and reinsurance ceded to nonaffiliates has fallen over the same period from an amount equal to 16.5 percent of direct premiums to 13.6 percent of direct premiums. In contrast, reinsurance assumed from affiliates grew over that period from an amount equal to 48.4 percent of direct premiums in 1990 to an amount equal to 65.0 percent in 2008, while insurance ceded to affiliates over the same period grew from an amount equal to 49.5 percent of direct premiums to an amount equal to 70.3 percent of direct premiums.[18]

Most of the growth in reinsurance assumed by domestic companies[19] in recent years is attributable to growth in affiliate reinsurance. In 2000, $233.9 billion in premiums were assumed by domestic reinsurers, $43.1 billion of which was assumed from unaffiliated insurers and $190.1 billion of which was assumed from affiliated insurers. Of the $364.7 billion in premiums assumed by domestic reinsurers in 2008, $44.4 billion was assumed from unaffiliated insurers and $320.3 billion of which was assumed from affiliated insurers. From 2000 to 2008, total premiums assumed by domestic reinsurers grew by 55.9 percent, of which premiums assumed from unaffiliated insurers grew by 3.0 percent and premiums assumed from affiliated insurers grew by 67.9 percent.[20]

Utilization of reinsurance varies by line of business. Table 1 reports various information on premiums for 2008, including various columns calculated from the underlying regulatory data. Gross premiums written represent U.S. direct business plus reinsurance assumed from nonaffiliates. This represents the total amount of business that companies could reinsure. "Net cessions to non-U.S. affiliates" reports the fraction of gross premiums written that are ceded to offshore reinsurers that are affiliates of U.S. companies.

For insurance groups headed by a U.S. parent, centralization of business from all of their affiliates within the United States results in a very small fraction of gross premiums ceded to

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[17] A.M. Best Company, "Best's Aggregates and Averages, Property/Casualty, United States and Canada," 1991 edition, at 82, and calculations of the staff of the Joint Committee on Taxation.

[18] A.M. Best Company, "Best's Aggregates and Averages, Property/Casualty, United States and Canada," 1991 and 2009 editions, at 82 and 146 respectively, and calculations of the staff of the Joint Committee on Taxation.

[19] These data do not specify whether the parent of an affiliated group including such a domestic company is a foreign parent or a U.S. parent.

[20] A.M. Best Company, "Best's Aggregates and Averages, Property/Casualty, United States and Canada," 2001 and 2009 editions, at 194 and 146 respectively, and calculations of the staff of the Joint Committee on Taxation.

foreign companies. Thus, most business ceded by U.S. companies to affiliates (column 4) also appears as reinsurance assumed by U.S. companies from affiliates (column 2).

For insurance groups headed by a foreign parent, the same business model results in almost no reinsurance ceded to affiliates appearing as reinsurance assumed by U.S. companies from affiliates. Thus, the industry average for this column obscures a high degree of variation in the underlying data.

"Cessions to Non-affiliates" reports the fraction of gross premiums written that are ceded to third party reinsurers. A wide degree of variation is evident in the use of third party reinsurance by line of business, ranging from 1.8 percent (Reinsurance: Non-proportional assumed financial lines) to 51.9 percent (Allied lines). The final column of Table 1 shows the percentage of net outflows offshore that go to affiliates offshore versus third party offshore reinsurers. For lines of business with a net inflow from offshore, or a net inflow from affiliates offshore, this statistic is not reported. For the industry as a whole, 53.7 percent of the net cessions offshore were to offshore affiliates, versus 47.3 percent to third parties offshore. This, too, evidences a wide degree of variation by line of business.

Table 1: Property Casualty Underwriting and Investment Exhibit Part 1B Premiums Written in Thousands of Dollars, 2008

	1	2	3	4	5	6=1+2+3-4-5	1+3	(4-2)/(1+3)	5/(1+3)	(4-2)/(1-6)
		Reinsurance Assumed		Reinsurance Ceded						
Line of Business	Direct Business	From Affiliates	From Non-Affiliates	To Affiliates	To Non-Affiliates	Net Premiums Written	Gross Premiums Written (GPW)	Net Cessions to Non-US Affiliates / GPW	Cessions to Non-Affiliates / GPW	Percentage of Net Offshore Cessions to Affiliates
Fire	12,069,005	7,127,311	1,940,502	8,084,150	3,101,363	9,951,305	14,009,507	6.8%	22.1%	45.2%
Allied lines	24,060,537	12,799,927	6,460,342	13,620,896	15,843,135	13,856,774	30,520,879	2.7%	51.9%	8.0%
Farmowners multiple peril	2,690,580	1,093,479	339,892	1,182,377	372,715	2,568,858	3,030,472	2.9%	12.3%	73.0%
Homeowners multiple peril	64,596,174	40,111,438	1,602,160	42,756,037	7,236,062	56,317,673	66,198,334	4.0%	10.9%	31.9%
Commercial multiple peril	34,815,878	29,850,463	956,583	31,430,470	4,104,590	30,087,864	35,772,461	4.4%	11.5%	33.4%
Mortgage guaranty	6,362,588	948,226	47,859	880,625	1,129,835	5,348,213	6,410,447	-1.1%	17.6%	NA
Ocean marine	3,937,609	3,490,407	697,205	4,023,366	1,027,359	3,074,497	4,634,814	11.5%	22.2%	61.7%
Inland marine	14,584,118	7,728,955	473,563	9,156,598	4,277,339	9,352,700	15,057,681	9.5%	28.4%	27.3%
Financial guaranty	3,227,980	587,092	909,818	440,039	1,120,536	3,164,315	4,137,798	-3.6%	27.1%	NA
Medical malpractice - occurrence	2,338,717	576,373	79,494	672,386	171,650	2,150,547	2,418,211	4.0%	7.1%	51.0%
Medical malpractice - claims made	8,391,330	1,854,346	373,150	2,562,282	1,024,357	7,032,188	8,764,480	8.1%	11.7%	52.1%
Earthquake	2,484,689	1,142,024	249,020	1,508,262	781,231	1,586,240	2,733,709	13.4%	28.6%	40.8%
Group accident & health	3,861,268	2,464,590	969,243	2,390,210	712,477	4,192,414	4,830,511	-1.5%	14.7%	NA
Credit A&H (group & individual)	639,727	77,301	62,705	80,681	308,667	390,385	702,432	0.5%	43.9%	1.4%
Other accident & health	3,288,637	578,647	278,782	1,239,110	285,272	2,621,684	3,567,419	18.5%	8.0%	99.0%
Workers' compensation	45,620,900	35,418,900	1,423,318	37,598,141	4,383,496	40,481,480	47,044,218	4.6%	9.3%	42.4%
Other liability - occurrence	32,287,433	25,045,888	2,235,951	28,759,935	5,835,902	24,973,435	34,523,384	10.8%	16.9%	50.8%
Other liability - claims made	17,736,021	11,131,685	1,313,655	13,073,322	2,737,323	14,370,716	19,049,676	10.2%	14.4%	57.7%
Products liability - occurrence	2,775,164	1,704,783	127,602	2,063,550	227,879	2,316,119	2,902,766	12.4%	7.9%	78.2%
Products liability - claims made	568,643	332,664	55,661	421,650	73,943	461,375	624,304	14.3%	11.8%	83.0%
Private passenger - auto liability	96,944,819	62,330,801	2,201,489	63,639,849	3,443,650	94,393,610	99,146,308	1.3%	3.5%	51.3%
Commercial - auto liability	20,337,277	15,585,575	1,007,055	17,089,309	2,107,160	17,733,438	21,344,332	7.0%	9.9%	57.8%
Auto physical damage	73,488,383	44,796,210	1,335,813	47,851,387	1,802,942	69,966,077	74,824,196	4.1%	2.4%	86.7%
Aircraft (all perils)	1,889,157	1,871,367	426,308	1,844,252	994,864	1,347,716	2,315,465	-1.2%	43.0%	NA
Fidelity	1,170,421	658,068	86,884	658,576	112,145	1,144,652	1,257,305	0.0%	8.9%	2.0%
Surety	5,473,072	2,836,994	410,385	3,235,907	559,604	4,924,940	5,883,457	6.8%	9.5%	72.8%
Burglary & theft	180,779	112,990	9,969	131,785	11,622	160,331	190,748	9.9%	6.1%	91.9%
Boiler & machinery	1,250,547	1,011,487	862,968	928,685	468,190	1,728,127	2,113,515	-3.9%	22.2%	NA
Credit	1,617,901	331,715	305,056	576,768	295,369	1,382,535	1,922,957	12.7%	15.4%	104.1%
International	66,985	527,691	225,149	476,445	54,591	288,788	292,134	-17.5%	18.7%	NA
Warranty	3,140,069	2,205,082	53,557	2,495,313	808,003	2,095,392	3,193,626	9.1%	25.3%	27.8%
Rein: Non-proportional assumed property	-	1,465,023	8,002,475	2,274,705	780,497	6,412,295	8,002,475	10.1%	9.8%	NA
Rein: Non-proporitonal assumed liability	-	2,355,358	8,503,806	3,098,161	575,290	7,185,713	8,503,806	8.7%	6.8%	NA
Rein: Non-proportional assumed financial lines	-	32,261	286,943	70,347	5,122	243,736	286,943	13.3%	1.8%	NA
Write-ins for other lines of business	984,278	121,451	68,297	230,153	191,096	752,778	1,052,575	10.3%	18.2%	47.0%
Total U/W & inv exhibit pt1b prem written	492,880,685	320,306,572	44,382,658	346,545,730	66,965,277	444,058,909	537,263,343	4.9%	12.5%	53.7%

With respect to insurance ceded to offshore reinsurers, according to the reinsurance industry national trade association Reinsurance Association of America, $58.2 billion of U.S. premiums were ceded to offshore reinsurers in 2008, $25.0 billion of which was ceded to unaffiliated offshore reinsurers and $33.2 billion of which was ceded to affiliated offshore reinsurers. These amounts compare to approximately $37.3 billion ceded to offshore reinsurers in 2001, $21.5 billion of which was ceded to unaffiliated offshore reinsurers and $15.9 billion of which was ceded to affiliated offshore reinsurers.

Hence, from 2001 to 2008, total premiums ceded to offshore reinsurers grew by 56.0 percent, of which premiums ceded to unaffiliated offshore reinsurers grew by 16.3 percent and premiums ceded to affiliated offshore reinsurers grew by 108.8 percent.[21] By comparison, total growth in net premiums written over this period was 35.0 percent.[22]

Markets for reinsurance have become global. Historically, London has been an insurance and reinsurance center. Very large reinsurers are also located in Germany and Switzerland. Bermuda is a large global reinsurance market.[23] Between 1983 and 2001, net premiums written in the Bermuda insurance market grew from $4.7 billion to $41.4 billion, and total assets in the Bermuda insurance market grew from $17.1 billion to $172.7 billion.[24] It is reported that capital grew 24 percent to $65 billion in 2006 among a group of Bermuda reinsurers, a doubling in their capital since 2002.[25] Bermuda is considered to have insurance regulatory rules favorable to insurance companies and products, and does not impose a corporate income tax. [26] However, more recently some have noted challenges in Bermuda.[27] In fact, several reinsurers have

[21] Reinsurance Association of America, *Offshore Reinsurance in the U.S. Market*, 2005 Data and 2008 Data, and calculations of the staff of the Joint Committee on Taxation.

[22] A.M. Best Company, "Best's Aggregates and Averages, Property/Casualty, United States and Canada," 2009 edition, at 369, and calculations of the staff of the Joint Committee on Taxation.

[23] See "Is Lloyd's Losing Out to Bermuda?," *Reactions Weekly News*, Aug. 1, 2002.

[24] See David Fox, "The Bermuda Market," in *Reinsurance: Fundamentals and New Challenges* (ed. Ruth Gastel), Insurance Information Institute (2004) at 137.

[25] Mark E. Ruquet, "Bermuda Reinsurers Had Record 2006 Results," *National Underwriter On-Line News Service*, March 23, 2007.

[26] See, e.g., *ibid.* at 140; Robert L. Carter and Leslie D. Lucas, *Reinsurance Essentials*, Reactions Publishing Group, 2004, at 256.

[27] See Caroline McDonald, "Bermuda Carriers Not Expected to Rush Off the Island Despite U.S. Tax Concerns," *National Underwriter*, October 19, 2009, available at http://www.property-casualty.com/Issues/2009/October-19-2009/Pages/Bermuda-Carriers-Not-Expected-To-Rush-Off-The-Island-Despite-US-Tax-Concerns.aspx, noting the increasing difficulty of obtaining work visas, limited space and other resources, and schooling for foreign workers' children.

redomiciled, or have announced plans to redomicile, from Bermuda to Europe.[28] Nevertheless, Bermuda is still the global leader in the reinsurance of U.S. risks.

Table 2[29] shows data on U.S. reinsurance premiums ceded to unaffiliated and affiliated offshore reinsurers by country of domicile. The top ten countries ranked by total reinsurance premiums are listed as well as the total for all other countries. Bermuda reinsurance companies accounted for 55.4 percent of total offshore reinsurance premiums in 2008, and 62.8 percent of all offshore affiliate reinsurance. Switzerland, the United Kingdom, Germany, and the Cayman Islands[30] round out the top five host countries for companies reinsuring U.S. risks. As illustrated in Table 2, Swiss companies write U.S. reinsurance business predominantly from their U.S. affiliates, while British and German companies assume reinsurance predominantly from unaffiliated U.S. primary insurers.

Table 2: 2008 U.S. Offshore Reinsurance Premiums
Thousands of Dollars

Country	Unaffiliated	Affiliated	Total
Bermuda	11,419,854	20,812,963	32,232,817
Switzerland	954,554	7,578,293	8,532,847
United Kingdom	4,427,642	823,361	5,251,003
Germany	2,793,354	1,222,361	4,015,715
Cayman Islands	2,002,840	389,042	2,391,882
Barbados	553,060	656,981	1,210,041
France	434,073	295,773	729,846
Ireland	485,320	155,148	640,468
Turks and Caicos Islands	518,369	111,179	629,548
Sweden	122,913	411,105	534,018
All Others	1,318,643	701,683	2,020,326
Total	25,030,622	33,157,889	58,188,511

[28] These include Flagstone Reinsurance Holdings which redomiciled to Luxembourg, and Amlin PLC and Catlin, which redomiciled to Switzerland. See Garry Booth, "Comment: Saying Bye-bye to Bermuda," reactionsnet.com, July 7, 2010.

[29] Data are reported by the Reinsurance Association of America based on ceded reinsurance as reported in annual statements filed with the NAIC. Reinsurance Association of America, *Offshore Reinsurance in the U.S. Market*, 2008 Data, and calculations of the staff of the Joint Committee on Taxation.

[30] Recently, companies have left the Cayman Islands to move their headquarters to Europe. XL Capital Ltd. moved its holding company domicile from the Cayman Islands to Ireland. "XL Completes Move to Ireland," *National Underwriter*, July 1, 2010, available at http://www.property-casualty.com/News/2010/7/Pages/XL-Completes-Move-To-Ireland.aspx. ACE Limited moved its place of incorporation from the Cayman Islands to Switzerland noting the "security of a network of tax treaties." Amanda Banks, "ACE to Redomicile in Switzerland," *Tax-news.com*, March 25, 2008, available at http://www.tax-news.com/news/ACE_To_Redomicile_In_Switzerland_____30408.html.

B. Federal Insurance Excise Tax

Table 3 provides information on the amount of Federal excise tax collected on policies issued by foreign insurers.[31] Data on excise tax collections are reported in the U.S. Department of the Treasury Monthly Treasury Statement and are published by the IRS Statistics of Income division.[32] Collections include amounts received from the excise taxes on casualty insurance and indemnity bonds, life insurance, sickness and accident policies, and annuity contracts, and reinsurance. Collections have grown by more than 15 percent per year since fiscal year 1999, but declined in fiscal year 2008 from their peak in fiscal year 2007.

Table 3
Federal Excise Tax Collections
Taxes on Policies Issued by Foreign Insurers

Fiscal Year	Thousands of Dollars
1999	117,584
2000	131,672
2001	152,221
2002	195,634
2003	292,897
2004	350,790
2005	373,580
2006	403,083
2007	427,637
2008	424,669

[31] Secs. 4371-4374. The description of present law regarding the excise taxes appears below.

[32] Statistics of Income, Internal Revenue Service, "Table 20. Federal Excise Taxes Reported to or Collected by the Internal Revenue Service, Alcohol and Tobacco Tax and Trade Bureau, and Customs Service, by Type of Excise Tax, Fiscal Years 1999-2008," available at http://www.irs.gov/pub/irs-soi/histab20.xls.

III. PRESENT LAW

Insurance companies in general

Subchapter L of the Code provides special rules for determining the taxable income of insurance companies. Separate sets of rules apply to life insurance companies and to property and casualty insurance companies. Insurance companies are subject to tax at regular corporate income tax rates.

Property and casualty insurers

Under present law, the taxable income of a property and casualty insurance company is determined as the sum of the amount earned from underwriting income and from investment income (as well as gains and other income items), reduced by allowable deductions.[33] For this purpose, underwriting income and investment income are computed on the basis of the underwriting and investment exhibit of the annual statement approved by the NAIC.[34]

Deduction for unpaid loss reserves

Underwriting income means premiums earned during the taxable year less losses incurred and expenses incurred.[35] Losses incurred include certain unpaid losses (reported losses that have not been paid, estimates of losses incurred but not reported, resisted claims, and unpaid loss adjustment expenses). Present law provides for the discounting of the deduction for loss reserves to take account partially of the time value of money.[36] Thus, present law limits the deduction for unpaid losses to the amount of discounted unpaid losses. Any net decrease in the amount of unpaid losses results in income inclusion, and the amount included is computed on a discounted basis.

The discounted reserves for unpaid losses are calculated using a prescribed interest rate that is based on the applicable Federal mid-term rate ("mid-term AFR"). The discount rate is the average of the mid-term AFRs effective at the beginning of each month over the 60-month period preceding the calendar year for which the determination is made.

To determine the period over which the reserves are discounted, a prescribed loss payment pattern applies. The prescribed length of time is either the accident year and the following three calendar years, or the accident year and the following 10 calendar years, depending on the line of business. In the case of certain "long-tail" lines of business, the 10-year period is extended, but not by more than five additional years. Thus, present law limits the maximum duration of any loss payment pattern to the accident year and the following 15 years.

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[33] Sec. 832.

[34] Sec. 832(b)(1)(A).

[35] Sec. 832(b)(3).

[36] Sec. 846.

The Treasury Department is directed to determine a loss payment pattern for each line of business by reference to the historical loss payment pattern for that line of business using aggregate experience reported on the annual statements of insurance companies, and is required to make this determination every five years, starting with 1987.

Under the discounting rules, an election is provided permitting a taxpayer to use its own (rather than an industry-wide) historical loss payment pattern with respect to all lines of business, provided that applicable requirements are met.

Reinsurance premiums deductible

In determining premiums earned for the taxable year, a property and casualty company deducts from gross premiums written on insurance contracts during the taxable year the amount of premiums paid for reinsurance.[37]

Unearned premiums

Further, the company deducts from gross premiums the increase in unearned premiums for the year.[38] The company is required to reduce the deduction for increases in unearned premiums by 20 percent. This amount serves to represent the allocable portion of expenses incurred in generating the unearned premiums, so as to provide a degree of matching of the timing of inclusion of income and deduction of associated expenses.

Proration of deductions relating to untaxed income

In calculating its reserve for losses incurred, a property and casualty insurance company must reduce the amount of losses incurred by 15 percent of (1) the insurer's tax-exempt interest, (2) the deductible portion of dividends received (with special rules for dividends from affiliates), and (3) the increase for the taxable year in the cash value of life insurance, endowment, or annuity contracts the company owns.[39] This rule reflects the fact that reserves are generally funded in part from tax-exempt interest, from wholly or partially deductible dividends, or from other untaxed amounts.

[37] Sec. 832(b)(4)(A).

[38] Sec. 832(b)(4)(B). Unearned premiums are generally those premiums received for insurance coverage in a future taxable year of the insurance company.

[39] Sec. 832(b)(5).

Treatment of reinsurance

In general

Present law includes a rule enacted in 1984 providing authority to the Treasury Department to reallocate items and make adjustments in reinsurance transactions to prevent tax avoidance or evasion.[40]

The rule permits the Treasury Department to make reallocations in related party reinsurance transactions. The rule was amended in 2004 to provide the Treasury Department with additional authority to allocate among the parties to a reinsurance agreement or to recharacterize income (whether investment income, premium, or otherwise), deductions, assets, reserves, credits, and any other items related to the reinsurance agreement, or to make any other adjustment to reflect the proper source, character, or amount of the item.[41] In expanding this authority to the amount (not just the source and character) of any such item, Congress expressed the concern that "reinsurance transactions were being used to allocate income, deductions, or other items inappropriately among U.S. and foreign related persons," and that "foreign related party reinsurance arrangements may be a technique for eroding the U.S. tax base."[42]

The rule also provides that if the Secretary determines that a reinsurance contract between insurance companies, whether related or unrelated, has a significant tax avoidance effect on any party to the contract, the Secretary may make an adjustment to one or both parties to eliminate the tax avoidance effect, including treating the contract as terminated on December 31 of each year and reinstated on January 1 of the next year. The legislative history provides that in determining whether a reinsurance agreement between unrelated parties has a significant tax avoidance effect with respect to one or both of the parties, appropriate factors for the Treasury Department to take into account are (1) the duration or age of the business reinsured, which bears on the issue of whether significant economic risk is transferred between the parties, (2) the character of the business (as long-term or not), (3) the structure for determining potential profits, (4) the duration of the reinsurance agreement, (5) the parties rights to terminate and the consequences of termination, such as the existence of a payback provision, (6) the relative tax positions of the parties, and (7) the financial situations of the parties.[43]

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[40] Sec. 845. See Conference Report to H.R. 4170, The Deficit Reduction Act of 1984, H. Rep. No. 98-861 (June 23, 1984), 1060.

[41] Section 803 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357.

[42] *See* Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress*, JCS-5-05, May 2005, 351.

[43] Conference Report to H.R. 4170, The Deficit Reduction Act of 1984, H. Rep. No. 98-861 (June 23, 1984), at 1063-4. In *Trans City Life Insurance Company v. Comm'r*, 106 T.C. 274 (1996), *nonacq*., 1997-2 C.B. 1, the Tax Court held that two reinsurance agreements did not have significant tax avoidance effects, based on the application of these factors.

Reinsurance premiums received by foreign persons

The United States employs a worldwide tax system under which U.S. persons (including U.S. citizens, U.S. resident individuals, and domestic corporations) generally are taxed on all income, whether derived in the United States or abroad. In contrast, foreign persons (including nonresident alien individuals and foreign corporations) are taxed in the United States only on income that has a sufficient nexus to the United States.

Foreign persons are subject to U.S. tax on income that is effectively connected with the conduct of a trade or business in the United States.[44] Such income may be derived from U.S. or foreign sources. This income generally is taxed in the same manner and at the same rates as income of a U.S. person. For this purpose, deductions are allowed only if and to the extent that they are connected with the income that is effectively connected with the conduct of a trade or business within the United States. In addition, foreign persons generally are subject to U.S. tax withheld at a 30-percent rate on certain gross income (such as interest, dividends, rents, royalties, and premiums) derived from U.S. sources.[45]

A foreign company carrying on an insurance business in the United States that would be treated as a life insurer or a property and casualty insurer for Federal tax purposes if it were a domestic corporation is subject to U.S. tax under subchapter L on its income effectively connected with its conduct of any trade or business within the United States.[46] Special rules apply to calculate the minimum effectively connected net investment income for this purpose.[47] Other U.S.-source income of such a foreign company carrying on an insurance business in the United States is subject to the 30-percent gross-basis withholding tax applicable generally to U.S.-source income of any foreign corporation.

Treasury regulations provide, however, that insurance premiums subject to the insurance or reinsurance excise tax (described below) are not subject to the 30-percent gross-basis withholding requirement applicable for income tax purposes.[48]

Securities trading safe harbor

Detailed rules govern whether trading in stocks or securities or commodities constitutes the conduct of a U.S. trade or business.[49] Under these rules (colloquially referred to as trading

[44] Sec. 882.

[45] Sec. 881.

[46] Sec. 842.

[47] Sec. 842(b). In *North West Life Assurance Co. of Canada v. Comm'r*, 107 T. C. 363 (1996), the Tax Court held that the business profits article of the United States-Canada income tax treaty permits a Canadian insurer doing business in the United States through a U.S. permanent establishment to attribute income to the permanent establishment based on its "real facts," not under the minimum investment income calculation of section 842(b).

[48] Treas. Reg. sec. 1.1441-2(a)(7); *see also* Treas. Reg. sec. 1.881-2(b).

[49] Sec. 864(b)(2).

safe harbors), trading in stock or securities or commodities by a foreign person through an independent agent such as a resident broker generally is not treated as the conduct of a U.S. trade or business if the foreign person does not have an office or other fixed place of business in the United States through which the trading is effected. Trading in stock or securities or commodities for the foreign person's own account, whether by the foreign person or the foreign person's employees or through a resident broker or other agent (even if that agent has discretionary authority to make decisions in effecting the trading) also generally is not treated as the conduct of a U.S. business provided that the foreign person is not a dealer in stock or securities or commodities.

Exemption from 30-percent withholding for certain investment income

The United States generally does not tax capital gains of a foreign corporation that are not connected with a U.S. trade or business. Although payments of U.S.-source interest that is not effectively connected with a U.S. trade or business generally are subject to the 30-percent withholding tax, there are significant exceptions to that rule. For example, interest from certain deposits with banks and other financial institutions is exempt from tax.[50] Original issue discount on obligations maturing in six months or less is also exempt from tax.[51] An additional exception is provided for certain interest paid on portfolio obligations.[52] Portfolio interest generally is defined as any U.S.-source interest (including original issue discount), not effectively connected with the conduct of a U.S. trade or business, (1) on an obligation that satisfies certain registration requirements or specified exceptions thereto, and (2) that is not received by a 10-percent shareholder.[53] This exception is not available for any interest received either by a bank on a loan extended in the ordinary course of its business (except in the case of interest paid on an obligation of the United States), or by a controlled foreign corporation from a related person.[54] Moreover, this exception is not available for certain contingent interest payments.[55]

Subpart F

Under the subpart F rules,[56] 10-percent U.S. shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, insurance income and foreign base company income (including foreign personal holding company income). The subpart F

[50] Secs. 871(i)(2)(A), 881(d).

[51] Sec. 871(g)(1)(B)(i).

[52] Secs. 871(h), 881(c).

[53] Sec. 871(h).

[54] Sec. 881(c)(3).

[55] Sec. 871(h)(4).

[56] Secs. 951-965.

rules generally do not apply in the case of a foreign corporation that is controlled by foreign persons.

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income").[57] In general, the availability of the exception for income derived in the active conduct of a banking, financing, or similar business requires that the CFC directly receive at least 70 percent of its gross income from the active and regular conduct of a lending or finance business from transactions with customers who are unrelated persons. Similarly, the exception for income derived in the active conduct of an insurance business generally applies only to income received from unrelated persons.

Branch level taxes

A U.S. corporation owned by foreign persons is subject to U.S. income tax on its net income. In addition, the earnings of the U.S. corporation are subject to a second tax, this time at the shareholder level, when dividends are paid. As discussed above, when the shareholders are foreign, the second-level tax is imposed at a flat rate and collected by withholding. Similarly, as discussed above, interest payments made by a U.S. corporation to foreign creditors are subject to a U.S. withholding tax in certain circumstances. Pursuant to the branch tax provisions, the United States taxes foreign corporations engaged in a U.S. trade or business on amounts of U.S. earnings and profits that are shifted out of, or amounts of interest deducted by, the U.S. branch of the foreign corporation.[58] The branch level taxes are comparable to these second-level taxes. In addition, where a foreign corporation is not subject to the branch profits tax as the result of a treaty, it may be liable for withholding tax on actual dividends it pays to foreign shareholders.

Insurance and reinsurance excise tax

An excise tax applies to premiums paid to foreign insurers and reinsurers covering U.S. risks.[59] The excise tax is imposed on a gross basis at the rate of one percent on reinsurance and life insurance premiums, and at the rate of four percent on property and casualty insurance premiums. The excise tax does not apply to premiums that are effectively connected with the conduct of a U.S. trade or business or that are exempted from the excise tax under an applicable income tax treaty. The excise tax paid by one party cannot be credited if, for example, the risk is reinsured with a second party in a transaction that is also subject to the excise tax.

Exemption from the excise tax

The United States has entered into comprehensive income tax treaties with more than 50 countries, including a number of countries with well-developed insurance industries such as

[57] Secs. 953(e) and 954(h) and (i), which expired December 31, 2009.

[58] Sec. 884.

[59] Secs. 4371-4374.

Barbados, Germany, Switzerland, and the United Kingdom. The United States has also entered into a tax treaty with Bermuda, another country with a significant insurance industry, which applies only with respect to the taxation of insurance enterprises.[60]

Certain U.S. tax treaties provide an exemption from the excise tax, including the treaties with Germany, Switzerland, and the United Kingdom.[61] To prevent persons from inappropriately obtaining the benefits of exemption from the excise tax, the treaties generally include an anti-conduit rule. The most common anti-conduit rule provides that the treaty exemption applies to the excise tax only to the extent that the risks covered by the premiums are not reinsured with a person not entitled to the benefits of the treaty (or any other treaty that provides exemption from the excise tax).[62]

The U.S. tax treaties with Barbados and Bermuda also provide an exemption from the excise tax, although the Senate's ratification of the U.S.-Bermuda treaty was subject to a reservation with respect to the treaty's application to the excise tax. Moreover, section 6139 of the Technical and Miscellaneous Revenue Act of 1988 provides that neither the U.S.-Barbados nor the U.S.-Bermuda treaty will prevent imposition of the excise tax on premiums, regardless of when paid or accrued, allocable to insurance coverage for periods after December 31, 1989.[63] Accordingly, no exemption from the excise tax is available under those two treaties with respect to premiums allocable to insurance coverage beginning on or after January 1, 1990.

Earnings stripping rules

A foreign parent corporation with a U.S. subsidiary may seek to reduce the group's U.S. tax liability by having the U.S. subsidiary pay deductible amounts such as interest, rents,

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[60] The U.S.-Bermuda treaty generally exempts from U.S. taxation the business profits of a Bermuda insurance enterprise from carrying on the business of insurance (including insubstantial amounts of income incidental to such business), unless the insurance enterprise carries on business in the United States through a U.S. permanent establishment. For the purposes of the treaty, an insurance enterprise is defined as an enterprise whose predominant business activity is the issuing of insurance or annuity contracts or acting as the reinsurer of risks underwritten by insurance companies, together with the investing or reinvesting of assets held in respect of insurance reserves, capital, and surplus incident to the carrying on of the insurance business. The treaty also includes a mutual assistance provision.

[61] Generally, when a foreign person qualifies for benefits under such a treaty, the United States is not permitted to collect the insurance premiums excise tax from that person.

[62] In Rev. Rul. 2008-15, 2008-1 C.B. 633, the IRS provided guidance to the effect that the excise tax is imposed separately on each reinsurance policy covering a U.S. risk. Thus, if a U.S. insurer or reinsurer reinsures a U.S. risk with a foreign reinsurer, and that foreign reinsurer in turn reinsures the risk with a second foreign reinsurer, the excise tax applies to both the premium to the first foreign reinsurer and the premium to the second foreign reinsurer. In addition, if the first foreign reinsurer is resident in a jurisdiction with a tax treaty containing an excise tax exemption, the Revenue Ruling provides that the excise tax still applies to both payments to the extent that the transaction violates an anti-conduit rule in the applicable tax treaty. Even if no violation of an anti-conduit rule occurs, under the Revenue Ruling, the excise tax still applies to the premiums paid to the second foreign reinsurer, unless the second foreign reinsurer is itself entitled to an excise tax exemption.

[63] Pub. L. No. 100-647.

royalties, and management service fees to the foreign parent or other foreign affiliates that are not subject to U.S. tax on the receipt of such payments. Although the United States generally subjects foreign corporations to a 30-percent withholding tax on the receipt of such payments, this tax may be reduced or eliminated under an applicable income tax treaty. Consequently, foreign-owned domestic corporations may seek to use certain treaties to facilitate earnings stripping transactions without having their deductions offset by U.S. withholding taxes.[64]

Present law limits the ability of corporations to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. A deduction for "disqualified interest" paid or accrued by a corporation in a taxable year is generally disallowed if two threshold tests are satisfied: the payor's debt-to-equity ratio exceeds 1.5 to 1 (the so-called "safe harbor" ratio); and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion).[65] Disqualified interest includes interest paid or accrued to: (1) related parties when no Federal income tax is imposed with respect to such interest; or (2) unrelated parties in certain instances in which a related party guarantees the debt ("guaranteed debt"). Interest amounts disallowed under these rules can be carried forward indefinitely. In addition, any excess limitation (i.e., the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

The earnings stripping rules generally apply to interest, but do not apply to other deductible payments such as insurance or reinsurance premiums.

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[64] For example, it appears that the U.S.-Barbados income tax treaty was used to facilitate earnings stripping arrangements in the context of corporate inversions. That treaty was amended in 2004 to make it less amenable to such use. It is possible, however, that other treaties in the U.S. network might be used for similar purposes. For a discussion of this issue, see Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty between the United States and Barbados* (JCX-55-04), September 16, 2004, at 12-20, 22.

[65] Sec. 163(j).

IV. LEGISLATIVE PROPOSALS

1. H.R. 3424 (111th Congress, introduced by Mr. Neal)

General rule

The provision disallows any deduction to covered insurance companies for excess reinsurance premiums with respect to U.S. risks paid to affiliated insurance companies that are not subject to U.S. income taxation. Thus, under the provision, the deduction for a portion of reinsurance premiums paid to affiliates may be disallowed.

Covered insurance company

A covered insurance company for this purpose is any company subject to tax imposed by section 831 of the Code. Thus, for example, a property and casualty insurance company subject to tax in the United States is considered a covered insurance company under the provision. The fact that a company subject to tax under section 831 has no tax liability for the taxable year (for example, due to losses) does not cause the company not to be considered as subject to tax under section 831. All domestic members of a controlled group of corporations (as defined in section 1563) of which a covered insurance company is a member are treated as one corporation.

The excise tax under section 4371 is disregarded for purposes of determining whether a company is a covered insurance company. Thus, for example, a foreign insurer or reinsurer that issues policies, premiums on which are subject to the excise tax under section 4371, and that is not subject to tax under section 831, is not considered a covered insurance company for purposes of this provision.

Under the provision, a corporation is treated as an affiliated corporation with respect to a covered insurance company if both corporations are members of the same controlled group of corporations. For this purpose, a controlled group of corporations is defined as in section 1563(a), except using a standard of "more than 25 percent" of the total vote or value of shares in lieu of "at least 80 percent."

Affiliated nontaxed reinsurance premiums

Under the provision, the deduction for excess reinsurance premiums is disallowed. Excess reinsurance premiums are those affiliated nontaxed reinsurance premiums paid during the taxable year by a covered insurance company in excess of the sum of (1) the premium limitation and (2) qualified ceding commissions with respect to such premiums.

An affiliated nontaxed reinsurance premium is any reinsurance premium paid, directly or indirectly, to an affiliated corporation if, with respect to the affiliated corporation, the premium is neither subpart F income nor subject to U.S. income tax.[66] Under a netting rule, the amount that would otherwise be treated as affiliated nontaxed reinsurance premiums with respect to a

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[66] For this purpose, the withholding tax under sections 1441 and 1442 is taken into account.

covered insurance company is reduced (but not below zero) by the amount of reinsurance premiums paid directly or indirectly to that company by that affiliated corporation during the taxable year. If any treaty between the United States and a foreign country reduces the U.S. income tax imposed on the premiums, then to that extent the premium is treated for this purpose as a premium on which no U.S. income tax is imposed (as under section 163(j)(5)(B)). For purposes of determining whether the premium is subject to U.S. income tax, the excise tax imposed by section 4371 is not taken into account.

Industry fraction

The premium limitation is determined by comparing a covered insurance company's reinsurance with an industry average amount of reinsurance based on an industry fraction of reinsurance. The industry fraction is used to determine the allowable amount of affiliate reinsurance. The numerator of the industry fraction is the industry aggregate reinsurance premiums paid by covered insurance companies to nonaffiliated corporations. The denominator of the industry fraction is the aggregate gross premiums written by covered insurance companies.

The industry fraction for each calendar year is determined, and is to be published, by the Treasury Department on the basis of published aggregate data from annual statements of insurance companies. The determination of the industry fraction is made separately for each line of business. Data for the second preceding calendar year are used in determining the industry fraction so as to allow time for the publication of aggregate industry data.[67]

Premium limitation

In determining the premium limitation for a line of its business for a taxable year, a company applies the industry fraction published by the Treasury Department for that line of business for the calendar year in which the company's taxable year begins. Under this rule, the industry fraction is multiplied by the company's gross premiums written for the line of business for the taxable year. Reinsurance premiums assumed from nonaffiliated corporations are treated in the same manner as gross premiums written directly by a covered insurance company. The amount of the premium limitation for any line of business for the taxable year is the excess of this product over the aggregate reinsurance premiums paid by the company that are not affiliated nontaxed reinsurance premiums (generally, that are premiums paid to nonaffiliated reinsurers). This is the maximum amount that is allowed as a deduction for reinsurance paid to affiliates under the provision. The amount of the premium limitation may not be less than zero.

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[67] Insurance companies make financial reports -- annual statements -- on forms prescribed by the National Association of Insurance Commissioners and file with the insurance commissioners of the States in which the companies are licensed to do business. In determining the industry fraction, it would be appropriate for the Treasury Department to employ insurance company annual statement data compiled by, for example, A.M. Best Company (e.g., A. M. Best Company, *Best's Aggregates and Averages, 2008 Edition*, which contains data from annual regulatory filings related to 2007), which it is understood that the Treasury Department also uses to determine loss payment patterns for purposes of the discounting rules applicable to property and casualty insurers under section 846 of the Code.

Application of the premium limitation does not result in the disallowance of any deduction for reinsurance premiums paid to persons that are not affiliated corporations (as defined under the provision). However, the provision operates by determining the deduction amount disallowed after taking into account premiums paid to corporations that are not affiliated. Thus, the provision disallows the deduction for reinsurance premiums paid to an affiliated corporation if the company's reinsurance premiums paid to corporations that are not affiliated exceed the amount of the company's premium limitation for that line of business.

Qualified ceding commissions

The amount of qualified ceding commissions is added to the premium limitation under the deduction disallowance rule of the provision. A qualified ceding commission for purposes of the provision is determined as a portion of the ceding commissions that are paid to a covered insurance company (and that are included in its income) with respect to the affiliated nontaxed reinsurance premiums paid by the covered insurance company during the taxable year. This portion is determined by the ratio of (i) the amount of such affiliated nontaxed reinsurance premiums paid by the company during the taxable year that exceeds the premium limitation for that year, to (ii) the aggregate amount of affiliated nontaxed premiums paid by the company that year.[68] Thus, under this rule, this treatment is provided for certain ceding commissions included in the taxpayer's income that are paid to the taxpayer with respect to otherwise nondeductible affiliated nontaxed reinsurance premiums. The inclusion of such ceding commissions in income offsets the potential for earnings stripping through the reinsurance transaction to the extent of the amount so included.

Election to treat specified reinsurance income as effectively connected

The provision provides an election for a foreign corporation to treat certain premiums and certain net investment income as subject to tax for U.S. income tax purposes. The election provides that a specified affiliated corporation may elect for any taxable year to treat specified reinsurance income as effectively connected with the conduct of a trade or business in the United States, and to be treated as carrying on an insurance business within the United States. Thus, an electing company is subject to the rules of present-law section 842 governing effectively connected income of foreign insurance companies carrying on an insurance business in the United States. As under present law, for purposes of this election, deductions are allowed only if and to the extent that they are connected with the income that is treated under this election as effectively connected with the conduct of a trade or business within the United States.

For purposes of this election, a specified affiliated corporation eligible to make the election is defined as an affiliated corporation that meets several requirements. First, it must be a foreign corporation that would qualify as a life insurance company or a property and casualty

[68] This calculation is to be made consistently with the applicable rules of the provision. Thus, for example, ceding commissions are determined separately for each line of business, and all domestic members of a controlled group of which a covered insurance company is a member are treated as one for this purpose.

insurance company for Federal income tax purposes if it were a domestic corporation.[69] Second, it must waive all benefits granted by the United States under any treaty between the United States and a foreign country with respect to specified reinsurance income to which the election applies.[70] Lastly, it must meet any requirements prescribed by the Treasury Department to ensure that U.S. tax on the specified reinsurance income is properly determined and paid. In prescribing these requirements, the Treasury Department is directed strictly to ensure that, for purposes of determining net investment income, only those deductible items directly allocable to gross investment income that is allocable to the specified reinsurance premiums are allowed.

For purposes of the election, specified reinsurance income means, with respect to any taxable year, (1) all reinsurance premiums that would (but for this election) be affiliated nontaxed reinsurance premiums (as defined under the provision) and that are received by a corporation during the taxable year directly or indirect from covered insurance companies with respect to which the corporation is affiliated, and (2) the net investment income (within the meaning of section 842(b)) for the taxable year allocable to reinsurance premiums with respect to which an election applies (whether for the current or a prior taxable year).

If a specified affiliated corporation is an affiliate of more than one covered insurance company, the election applies with respect to all such covered insurance companies. The election may be revoked only with the consent of the Secretary.

Regulatory authority

The provision grants regulatory authority to carry out or to prevent the avoidance of the purposes of this provision. In particular, the Treasury Department is directed to identify, and to prevent avoidance of the provision through, transactions that are alternatives to traditional reinsurance, through fronting transactions, conduit and reciprocal transactions, and through any economically equivalent transactions. The Treasury is directed to publish guidance relating to prevention of avoidance of the purposes of the provision as promptly as possible, and is directed to make such guidance effective at a time consonant with the statutory effective date.

Effective date

The provision is effective for taxable years beginning after December 31, 2009.

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[69] Present-law rules providing that a foreign corporation is not an includable corporation for purposes of an affiliated group filing a consolidated return continue to apply (secs. 1502, 1504(b)(3)). Thus, specified reinsurance income (or loss, if any) of an electing company cannot be taken into account on a U.S. consolidated return.

[70] Because an electing company must waive all treaty benefits granted by the United States with respect to the specified reinsurance income, the reasoning of the *North West* case, above, which interpreted a treaty provision to prevent the application of the section 842(b) calculation of minimum effectively connected net investment income, does not apply.

2. President's Fiscal Year 2011 Budget Proposal[71]

General rule

The proposal disallows any deduction to covered insurance companies for a certain fraction of reinsurance premiums with respect to U.S. risks paid to foreign affiliated insurance companies that are not subject to U.S. income taxation.

Covered insurance company

A covered insurance company for this purpose is any company subject to tax imposed by section 831 of the Code. Thus, for example, a property and casualty insurance company subject to tax in the United States is considered a covered insurance company under the proposal. The fact that a company subject to tax under section 831 has no tax liability for the taxable year (for example, due to losses) does not cause the company not to be considered as subject to tax under section 831. All domestic members of a controlled group of corporations (as defined in section 1563, but using a 50-percent ownership threshhold) of which a covered insurance company is a member are treated as one corporation.

The excise tax under section 4371 is disregarded for purposes of determining whether an affiliated insurance company is subject to U.S. income taxation.[72] Thus, for example, a foreign insurer or reinsurer that issues policies, premiums on which are subject to the excise tax under section 4371, and that is not subject to tax under section 831, is not considered an affiliated insurance company subject to U.S. income taxation for purposes of this proposal.

Deduction disallowed for certain reinsurance premiums

Under the proposal, the deduction for certain reinsurance premiums is disallowed. The amount disallowed for each line of business is the amount of reinsurance premiums paid (net of ceding commissions) in excess of 50 percent of premiums received by the taxpayer and its U.S. affiliates for direct insurance of U.S. risks.

Election to treat specified reinsurance income as effectively connected

The proposal provides an election for affiliated foreign reinsurers to be subject to U.S. tax on premiums and net investment income that is associated with affiliated reinsurance transactions. This election is intended to provide that these foreign affiliates are not treated less favorably than U.S. reinsurers, in the event that the proposal could be viewed as discriminatory under the nondiscrimination article of any U.S. tax treaty.

The election provides that an affiliated corporation may elect for any taxable year to treat certain premiums and certain net investment income as effectively connected with the conduct of

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[71] See *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals*, Department of the Treasury, February 2010, 45.

[72] Although this is not specified in the Budget Proposal, it is understood that this is the intent.

a trade or business in the United States, and to be treated as carrying on an insurance business within the United States. Thus, an electing company is subject to the rules of present-law section 842 governing effectively connected income of foreign insurance companies carrying on an insurance business in the United States. As under present law, for purposes of this election, deductions are allowed only if and to the extent that they are connected with the income that is treated under this election as effectively connected with the conduct of a trade or business within the United States.

For purposes of the election, specified reinsurance income means, with respect to any taxable year, (1) all reinsurance premiums for which (but for this election) a deduction would be disallowed and that are received by a corporation during the taxable year directly or indirectly from covered insurance companies with respect to which the corporation is affiliated, and (2) the net investment income (within the meaning of section 842(b)) for the taxable year allocable to reinsurance premiums with respect to which an election applies (whether for the current or a prior taxable year). The election may be revoked only with the consent of the Secretary.

Effective date

The proposal is effective for taxable years beginning after December 31, 2010.

3. Proposals in prior Congresses

H.R. 1755 (107th Congress)

H.R. 1755, "Reinsurance Tax Equity Act of 2001," was introduced in the House of Representatives by Nancy Johnson and Richard Neal during the 107th Congress on May 8, 2001. The bill would amend section 832(b)(4) of the Code to deny a deduction for premiums paid for direct or indirect reinsurance of U.S. risks with a "related insurer" in certain circumstances. However, when calculating its taxable income, an insurance company may generally deduct reinsurance recovered from a related insurer to the extent a deduction for the premium paid for the reinsurance was disallowed as a result of the bill. A U.S. risk includes any risk related to property in the United States, or liability arising out of the activity in, or in connection with the lives or health of residents of, the United States. A "related insurer" means a reinsurer owned or controlled directly or indirectly by the same interests (within the meaning of section 482) as the person making the premium payment.

The deduction is not denied if: (1) the income attributable to the reinsurance to which such premium relates is includible in the gross income of such reinsurer or one or more domestic corporations or citizens or residents of the United States; or (2) the related insurer establishes to the satisfaction of the Treasury Secretary that the taxable income (as determined under section 832) attributable to the reinsurance is subject to an effective rate of income tax imposed by a foreign country greater than 20 percent of the maximum rate specified in section 11 of the Code. A related insurer may elect to treat income from the reinsurance of U.S. risks, which is not otherwise includible in gross income, as income that is effectively connected with the conduct of a U.S. trade or business.

H.R. 4192 (106th Congress)

H.R. 4192 was introduced in the House of Representatives by Nancy Johnson and Richard Neal during the 106th Congress on April 5, 2000. This bill would amend section 845 to alter the treatment of related-party reinsurance. Under the bill, if a domestic person directly or indirectly reinsures a United States risk with a related foreign reinsurer, then the investment income of the domestic person shall be increased each year by an amount equal to the product of (1) the average of the applicable Federal mid-term rates determined under section 1274(d)(1) and (2) the sum of the reserves and liabilities related to the U.S. risks ceded to the foreign reinsurer as shown on the national statement approved by the National Association of Insurance Commissioners. A U.S. risk includes any risk related to property in the United States, or liability arising out of the activity in, or in connection with the lives or health of residents of, the United States. An insurer is a "related foreign insurer" with respect to any domestic person if such person and foreign insurer are owned or controlled directly or indirectly by the same interest (within the meaning of section 482).

Generally, this rule is not applicable if: (1) the foreign reinsurer retaining the reinsurance includes the income attributable to the reinsurance of the U.S. risks on its U.S. tax return either as a result of having made an election to be taxed as a domestic insurance company under section 953(d) or because such income is effectively connected with the foreign reinsurer's U.S. trade or business; (2) the foreign reinsurer elects to file a tax return and pay tax on income from the reinsurance of U.S. risks ceded to it by related domestic persons as if such income were effectively connected to a U.S. trade or business; (3) one or more domestic corporations or U.S. individuals include the income attributable the reinsurance of the U.S. risks ceded to the related foreign reinsurer on its tax return under subpart F; or (4) the foreign reinsurer establishes to the satisfaction of the Treasury Secretary that the taxable income (as determined under section 832) attributable to the reinsurance is subject to an effective rate of income tax imposed by a foreign country greater than 20 percent of the maximum rate specified in section 11 of the Code.

The one-percent excise tax on premiums paid to foreign reinsurers does not apply to premiums to which the bill applies.

V. ISSUES AND ANALYSIS

Overview

Reasons for reinsurance transactions

Both domestically-controlled and foreign-controlled insurance companies regularly cede a portion of their U.S. risks to affiliated or unaffiliated U.S. or foreign reinsurers. The shifting, redistribution, and geographic diversification of risks are undertaken for a variety of business reasons.

A principal reason for reinsurance transactions is simply to shift or redistribute risk, because an insurer's pool of risks is too concentrated in some manner. In the case of affiliate reinsurance, economies of scale in managing risk may make it attractive to use reinsurance to consolidate the risks of an affiliated group in one entity, before subsequently shifting the risk to third parties or managing risk within the group. Reinsurance transactions also serve to move capital among members of an affiliated group, whether to centralize the capital for efficient management or to shift it where needed to cover insured losses. Additional nontax reasons for engaging in reinsurance transactions -- whether assuming or ceding risks through reinsurance transactions -- involve reduction in business volatility by managing exposure to extremely large losses, compliance with State or other governmental regulatory requirements for capital and surplus, minimizing multiple layers of regulation or consolidating regulatory oversight in a business-favorable jurisdiction, financing growth of existing and new lines of business, and diversification by acquisition or divestiture of blocks of business or entire lines of business.[73]

Summary of tax issues relating to foreign affiliate reinsurance

U.S. Federal income tax advantages may also motivate reinsurance transactions to some degree. The concerns arise in the context of reinsurance of risks by U.S. insurers with foreign affiliates in multinational groups with a foreign corporate parent. Concerns about tax issues relating to foreign affiliate reinsurance transactions fall generally into three categories. One tax issue relates to transfer pricing difficulties. Another is a concern about the opportunity for earnings stripping through reinsurance transactions with foreign affiliates. A further issue has to do with the impact of U.S. tax rules on the relative competitiveness of U.S. reinsurers on the one hand, and nondiscrimination in connection with foreign reinsurers on the other hand. These issues are discussed below.

Transfer pricing issues

Due to the variation in tax rates and tax systems among countries, a multinational enterprise, whether U.S.-based or foreign-based, may have an incentive to shift income, deductions, or tax credits among commonly controlled entities in order to arrive at a reduced overall tax burden. Within a controlled group, there are no market pressures that impose market pricing on transactions between related parties, though insurance regulators in many jurisdictions

[73] Reasons for reinsurance transactions are described in more detail in Part I of this document.

would be likely to monitor reinsurance transactions for reasonableness of the price. The lack of an identifiable market price provides opportunities for companies to shift income among group members through controlled transactions at off-market prices.

The fact that risks reinsured with affiliates do not always generate profits, but sometimes give rise to losses, might suggest that there is not a transfer pricing problem in the reinsurance area. The fact that the reinsured business is not exclusively profitable could be construed as support for the idea that the transfer pricing is not incorrect. The fallacy of this reasoning, however, is that the reinsurance premium is priced based on an expectation of the costs of insuring the risk. The fact that the adverse event takes place, or that the cost of the adverse event is greater than anticipated when it actually occurs, does not change the assumptions that were made at the time the premium was originally priced.

In the reinsurance context, present law accords the Treasury Department specific authority to address transfer pricing concerns. To preserve the U.S. tax base, section 845 authorizes the Secretary of the Treasury to (1) allocate between or among two or more related persons (within the meaning of section 482) items of income (whether investment income, premium, or otherwise), deductions, assets, reserves, credits, and other items); (2) recharacterize any such items; or (3) make any other adjustment to reflect the proper amount, source, or character of the taxable income (or any item described in (1) relating to such taxable income) of each person. Section 845 generally does not prescribe any specific reallocation rules. Rather, it establishes the general standards of preventing tax evasion and clearly reflecting income. Treasury regulations under section 482 adopt the concept of an arm's length standard as the method for determining whether reallocations are appropriate. Thus, the regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been uncontrolled parties dealing at arm's length.

The premium and ceding commission on reinsurance may be analogous to a transfer price for the underlying insurance risk. Following this analogy, a concern about excess affiliated reinsurance may be viewed as a concern about the transfer price. It could be argued that present-law Treasury authority under section 845 to allocate income and deductions among related persons, along with the presence of comparable third-party reinsurance transactions, is sufficient to combat any abuse in this area.

The idea that third-party reinsurance is truly comparable in price to related party insurance could be questioned on the grounds of asymmetry of information[74], as well as other grounds. One of the purposes of affiliate reinsurance may be to mitigate the effect of asymmetric information on increasing the price charged for reinsurance risk. That is, a third party may need to charge a higher premium than would a related reinsurer with greater knowledge about the risk. The higher premium serves to compensate the third party reinsurer for the uncertainty regarding the true nature of the risk being transferred. In effect, it could be said that there is an asymmetry of information as between third party reinsurance and affiliate

[74] Michael Cragg, J. David Cummins, and Bin Zhou, *The Impact on the U.S. Insurance Market of a Tax on Offshore Affiliate Reinsurance: An Economic Analysis*, The Brattle Group, May 1, 2009, 8.

reinsurance. This asymmetry suggests that third-party reinsurance is an imperfect standard by which to judge the appropriateness of the transfer price for the insurance risk in the case of affiliated reinsurance. To the extent that the third-party reinsurance premium is too high (or the ceding commission is too low) as a standard of comparison, it would lead to an understatement of income for the ceding company and an overstatement of income for the assuming company in the case of affiliated reinsurance.

Another aspect of the transfer pricing issue relates to whether growth in related party transactions raises a transfer pricing concern. The growth from 2001 to 2008 in the amount of premiums ceded to unaffiliated offshore reinsurers as compared with affiliated offshore reinsurers (16.3 percent versus 108.8 percent)[75] suggests that related parties may be ceding a greater proportion of their premiums through reinsurance than are unrelated parties. Growth of affiliated offshore reinsurance could increase the potential for a transfer pricing problem. However, if data over differently determined time periods are taken into account, these percentages could be different.[76]

A transfer pricing concern is also raised in statements in the legislative history of the 2004 amendment to section 845(a) with respect growth of offshore affiliate reinsurance.[77] If this analysis is accurate, the IRS may be able to apply section 845 in a particular case to reallocate income and deductions between such related parties on the basis of the argument that an unrelated party would not have reinsured such a large proportion of its U.S. risks.

However, the IRS might be unsuccessful in challenging the questioned transactions. Further, it is difficult to obtain consistent results on a case by case basis applying transfer pricing concepts. Although it is possible to characterize the growth in affiliated reinsurance transactions as a transfer pricing issue, applying a set of definitive rules similar to the earnings stripping rules might have a more systematic effect than relying on transfer pricing principles on a case by case basis.

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[75] As discussed in more detail in Part II of this document, from 2001 to 2008, total premiums ceded to offshore reinsurers grew by 56.0 percent, of which premiums ceded to unaffiliated offshore reinsurers grew by 16.3 percent and premiums ceded to affiliated offshore reinsurers grew by 108.8 percent.

[76] From 2005 (the year of several U.S. hurricanes) to 2008, for example, total premiums ceded to offshore reinsurers fell by 6.2 percent. While premiums ceded to unaffiliated offshore reinsurers grew by 7.7 percent during this period, premiums ceded to affiliated offshore reinsurers fell by 14.6 percent during the period. However, the amount of affiliate offshore reinsurance in 2008 exceeded the amount of affiliate offshore reinsurance in the year preceding this period, 2004. See Reinsurance Association of America, *Offshore Reinsurance in the U.S. Market*, 2008 Data, 8, and calculations of the staff of the Joint Committee on Taxation.

[77] See discussion in the Present law section of this document relating to the treatment of reinsurance and section 845 of the Code.

Earnings stripping

Historical rationale for earnings stripping rules

Congress has provided a set of rules that disallow deductions for amounts of interest deemed to be excessive in the case of the systematic reduction of the U.S. tax base of a U.S. foreign controlled company by its foreign parent by means of interest deductions – known as earnings stripping.[78] The present-law rules relating to earnings stripping through interest deductions apply regardless of the taxpayer's or related creditor's intent or the existence of a valid business purpose for the debt. Indeed, it may be presumed that the debt qualifies as such under general debt-equity principles and that there is a valid business purpose for such debt. The earnings stripping rules operate in a mostly mechanical fashion to disallow the portion of the foreign controlled company's interest deduction over a certain threshold. The disallowed deductions may be carried forward indefinitely for use in future years.

The earnings stripping rules are generally not affected by U.S. income tax treaties because they affect residents of the United States, not residents of treaty countries. When it enacted these rules, Congress did not believe they violated U.S. treaty obligations. The Committee on Ways and Means stated that "[t]he committee does not believe that the impact of this limitation on foreign-owned entities violates any treaty nondiscrimination provision….If the committee should be incorrect in its technical interpretation of the interaction between this provision and U.S. treaties, however, it does not intend that any contrary treaty provision defeat its purpose in enacting this limitation."[79]

Foreign related-party reinsurers and earnings stripping

In the case of foreign-based companies that reinsure policies issued or reinsured by independent or affiliated U.S. insurance companies, a well-advised reinsurer may in most cases avoid being engaged in a trade or business and having a permanent establishment in the United States by not having an office in the United States, by keeping separate the affairs of the foreign and U.S. companies, and by carefully following the formalities of contracts.[80] In that case, the U.S. insurer may deduct its reinsurance premiums; those premiums are subject to neither net income nor withholding tax by the United States, notwithstanding that the reinsurance covers

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[78] Sec. 163(j). Those rules are discussed in the Present Law section of this document. The President's budget proposals have previously included a proposal to further restrict certain related-party interest deductions. See Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2008 Budget Proposal* (JCS-2-07), March 21, 2007, at 209.

[79] H. Rep. No. 101-247, 101st Cong., 1st Sess. 1249 (1989). *See also* Omnibus Budget Reconciliation Act of 1989, Conference Report, H.R. Rep. No. 101-386, 101st Cong., 1st Sess. 568 ("The conferees believe that the conference agreement does not violate treaties.")

[80] A business arrangement under which an insurer cedes most of its risks to one reinsurer is known in the insurance industry as "fronting." Fronting raises issues of whether the insurer is acting as an agent of the reinsurer, and whether a foreign reinsurer is engaged in a trade or business in the United States, and if so, whether the activities result in the reinsurer having a permanent establishment in the United States to which the ceded premiums are attributable.

U.S. risks. The tax cost of such an arrangement is the one-percent excise tax on the reinsurance premiums,[81] plus any U.S. income tax imposed on ceding commissions paid by the reinsurer to the ceding insurer. The premiums may or may not be subject to tax in the country in which the foreign reinsurer is resident, depending on the tax law there. Further, because the premiums are actually paid to the foreign reinsurer, it may invest these funds, including in the United States. In so doing, it may avail itself of potentially low local tax rates, as well as, in the case of U.S. investment, the "securities trading safe harbor" tax exemption of section 864(b) and other portfolio investment exemptions.[82] At the same time, a related foreign reinsurer's consolidated financial statements are not affected by such related-party reinsurance transactions.

This tax profile contrasts with that of U.S.-based reinsurers, whose U.S. companies' income is subject to taxation in the United States when earned and whose controlled foreign corporations' insurance income is generally subject to U.S. tax under subpart F.[83] The distribution of share ownership of a foreign corporation may determine, in part, whether it and its foreign subsidiaries are subject to the controlled foreign corporation tax regime or are able to obtain the superior tax treatment accorded other foreign corporations. A foreign corporation that is majority-owned, or even 100-percent-owned, directly or indirectly, by U.S. persons is not a controlled foreign corporation if its ownership is dispersed such that the majority of the voting power or value of the foreign corporation is not owned, directly or indirectly, by U.S. persons owning 10 percent or more of the voting power of the corporation's stock.

Earnings stripping transactions can involve the payment of deductible amounts other than interest, it can be argued. If the rationale for the earnings stripping rules applies to foreign related-party reinsurance transactions, then it should be possible to devise a set of rules analogous to those of section 163(j) that would disallow, and possibly defer, deductions for ceding "excessive" reinsurance premiums covering U.S. risks paid by foreign controlled companies to foreign related persons, notwithstanding any current tax treaty provision.[84]

Despite the broad similarity between earnings stripping and foreign related-party reinsurance transactions, the analogy is imperfect, some argue. For example, by contrast to the interest deduction situation, the reinsurance premium received by a foreign reinsurer is subject to the U.S. reinsurance excise tax. In addition, the reinsurance transaction normally involves ceding commissions that are treated as income of the ceding company, although these could

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[81] Sec. 4371. Some U.S. tax treaties provide an exemption from the excise tax, as described in the Present Law section of this document. For example, under the U.S.-Switzerland, U.S.-United Kingdom, and U.S.-Germany tax treaties, the excise tax does not apply to reinsurance premiums paid to residents of Switzerland, the United Kingdom, and Germany, respectively. In contrast, neither the U.S.-Bermuda tax treaty nor the U.S.-Barbados tax treaty generally provide an exemption from the excise tax. *See* the Present Law section of this document.

[82] The cumulative benefits of such low-taxed or nontaxed investment may be greater in the case of longer-term investments, such as the investment of premiums from long-tail lines.

[83] In general, income from related-party reinsurance and reinsurance of U.S. risks are not exempt from subpart F. Secs. 953(e) and 954(i).

[84] Such rules could also be applied to related party guarantee or conduit arrangements that are similar in effect to back-to-back loans.

alternatively be viewed as simply netting against, or reducing, the reinsurance premium received by the foreign reinsurer, conceptually. Further, reinsurance transactions involve risk of another person (the insured), whereas earnings stripping on the basis of deductible interest can be a two-party transaction between a U.S. payor and its foreign affiliated lender. Another distinction is that by paying premiums, an insurer generally decreases its financial leverage and debt-equity ratio, unlike the earnings stripping-by-debt scenario, in which these are increased. The paying of reinsurance premiums thus increases the ceding company's financial and regulatory capacity to write (or reinsure) more risks, which may, in turn, be ceded. By contrast, increased debt (to which the interest earnings stripping rules apply) reduces the taxpayer's capacity to expand and to take on more debt.

If, however, the similarity of foreign related-party reinsurance transactions to earnings stripping is accepted, an earnings stripping provision applicable to reinsurance transactions could disallow deductions for premiums for U.S. risks ceded to a related person that is not subject to U.S. tax on the income.[85]

One general approach might be to closely follow the rules of section 163(j) to disallow a deduction for the amount of reinsurance premiums paid to foreign related parties to the extent the amount of reinsured premiums exceeds some specified percentage of an amount similar to "adjusted taxable income."[86] As in the case of interest earnings stripping, disallowed deductions and an attribute analogous to "excess limitation" could be carried forward from prior years and taken into account.[87] It could be argued that an earnings stripping rule relating to reinsurance should apply only to the extent a corporation has positive income in the year of the deduction disallowance, so that there is not a mismatch between the corporation's economic situation and its Federal income tax treatment. This result is achieved to some degree under the present-law earnings stripping rules for interest, by defining disallowed "excess interest expense" to mean the excess of the corporation's net interest expense over half of its adjusted taxable income for the year (plus any excess limitation carryforward). Under this approach, an interest deduction is generally not disallowed unless the taxpayer has some positive income for the taxable year, or has an excess limitation carryforward from a prior year. On the other hand, because the present-law limitation amounts are carried forward to prevent avoidance of the rule, it is possible the interest deduction limitation applies in a year when the corporation does not have positive taxable income. Moreover, the carryforward rule could be criticized as complex and as not achieving a result that is substantively very different, in the end, from a rule without the adjusted taxable income requirement coupled with a carryover rule.

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[85] A person could be considered not subject to U.S tax to the extent of a treaty or Code reduction in withholding or other tax, including the elimination of withholding tax on premiums under Treasury Regulation section 1.1441-2(a)(7). For this purpose, the imposition of the one-percent excise tax on reinsurance premiums is not taken into account.

[86] Sec. 163(j)(6)(A). Adjusted taxable income is the taxpayer's taxable income computed without regard to any deductions for net interest expense, net operating losses, income attributable to domestic production activities, depreciation, amortization, depletion, and adjustments provided in regulations.

[87] Sec. 163(j)(1)(B) and (2)(B)(ii)-(iii). Excess limitation is the excess of 50 percent of adjusted taxable income over the amount of net interest expense (which is interest expense less interest income).

The earnings stripping rules for interest deductions do not apply unless foreign controlled company's debt-to-equity exceeds a safe-harbor ratio of 1.5 to 1.[88] This amount is generally designed to be greater than the median debt-to-equity ratio of U.S. corporations.[89] As in the case of those earnings stripping rules, providing an overall safe harbor could protect the companies from disallowance of deductions due to year-to-year changes in profitability. Such a safe harbor could be based on concepts analogous to the debt-equity ratio, for example, a median percentage of premiums ceded to unrelated parties on a group basis. This ratio could be determined on the basis of overall industry transactions pertaining to unrelated party transactions, by lines of business, or based on some fixed criteria (as in section 163(j)).

An alternative line-drawing approach might be to attempt to match the foreign controlled company's premium-ceding tax burden with the tax burden that is imposed on U.S.-based insurers ceding premiums to their controlled foreign corporations. Proponents of such an approach might view this type of equalization approach as an opportunity to reform or reduce the current system of subpart F taxation of insurance income.[90]

In assessing the merits of the earnings stripping approach, one view is that earnings stripping rules for reinsurance transactions with foreign affiliates are necessary to place U.S.-owned and foreign-controlled insurance companies on a level playing field. Further, such rules would serve to prevent other forms of earnings stripping in addition to interest. The U.S. property and casualty market would not be disrupted by a change in the tax rules, and premium levels would not be any higher than the premiums currently charged by U.S. insurers who are unable to cede their premiums to an untaxed or low-taxed foreign parent. Because earnings stripping-type rules are not dependent upon tax treaties or foreign effective tax rates, the impact of an earnings stripping regime may not be circumvented by moving foreign reinsurance operations to another foreign country. At the same time, the addition of earnings stripping rules for affiliate reinsurance would stem the flow from the United States of earnings relating to insurance and reinsurance of U.S. risks.

On the other hand, because there are a number of business reasons for reinsurance, arguably there should not be a formulaic limit imposed on deductions for ceded risks. Applying earnings stripping rules to related-party reinsurance could cause property and casualty insurance coverage to become more difficult to obtain or could make such coverage more expensive, or even unavailable. Further, adding more deduction disallowance rules to the tax law increases complexity for taxpayers and the government. Moreover, taxpayers could still strip earnings using deductible payments other than interest or reinsurance premiums, so the change may have the perverse effect of increasing taxpayer motivation to engage in economically inefficient tax-motivated stripping transactions of other types.

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[88] Sec. 163(j)(2)(A)(ii).

[89] H. R. Rep. No. 101-386, 101st Cong., 1st Sess. 567 (1989).

[90] Secs. 953 and 954(i).

A potential benefit of an earnings stripping-type regime for affiliate reinsurance is that it would minimally interfere with the operation of tax treaties and therefore it would be difficult or impossible to avoid such a regime by using a tax treaty. Another view is that such rules violate the spirit, if not the letter, of tax treaties.

Summary of differences between H.R. 3424 and the Administration proposal

Both H.R. 3424 and the Administration fiscal year 2011 budget proposals include a deduction disallowance proposal relating to reinsurance that reflect earnings stripping concerns. Both proposals impose a premium deduction limitation for reinsurance premiums paid to foreign affiliates if the level of reinsurance for the line of business exceeds a threshold.

H.R. 3424 differs from the Administration proposal in several respects. A 50-percent threshold based on direct insurance with respect to each line of business applies under the premium deduction limitation in the Administration proposal. H.R. 3424 applies a premium deduction limitation based on industry average reinsurance premiums for each line of business. Under H.R. 3424, the premium deduction limitation is determined by comparing a covered insurance company's reinsurance with an industry average amount of reinsurance for that line of business, which is determined and published annually by the Treasury Department on the basis of published aggregate data from annual statements of insurance companies.

Other differences between the two proposals apply. Instead of applying the deduction disallowance rule only to direct business as under the Administration proposal, H.R. 3424 applies a deduction disallowance rule to both direct and assumed business. Instead of netting all ceding commissions to foreign reinsurers as under the Administration proposal, H.R. 3424 increases the premium limitation only for the portion of ceding commissions that are allocable to disallowed reinsurance premiums and that are subject to U.S. income tax. The two proposals differ in other more minor respects as well.

Alternative approaches to addressing earnings stripping

Reduce U.S. tax on insurance income

Alternatives to a deduction disallowance approach could also address earnings stripping concerns with respect to reinsurance. One possible way to address the differential taxation of U.S. and foreign-based reinsurers might be to lower the U.S. corporate income tax rate on domestic reinsurers (or on domestic insurance in general) or to provide other incentives with similar effects. Such benefits could possibly be limited to certain lines of business. However, such actions would have very little effect on the underlying business purposes claimed by such reinsurers.

U.S.-Bermuda tax treaty

Another possible option for consideration is to address Bermuda-based reinsurers, in part by terminating the U.S.-Bermuda income tax treaty pertaining to insurance and mutual

assistance.[91] That treaty is unique in that it provides no tax benefits for residents of the United States and therefore is a departure from the tax treaty model of reciprocal tax benefits.[92]

Terminating the U.S.-Bermuda insurance tax treaty, however, might by itself have little or no effect on Bermuda reinsurers, because Bermuda reinsurance companies that do not have a permanent establishment in the United States also might not be engaged in a trade or business in the United States (or might be able to alter their activities to avoid being engaged in a U.S. trade or business). Moreover, Treasury Regulation section 1.1441-2(a)(7) precludes the United States from imposing withholding tax on insurance premiums paid with respect to contracts subject to the section 4371 excise tax (which includes reinsurance premiums ceded to Bermuda companies).[93]

Reinsurance excise tax

Another alternative that might be considered would be to increase the foreign reinsurance excise tax rates generally and coordinate them with the tax treaties, including possibly applying higher rates on certain long-tail coverage to take account of the longer period over which

[91] The treaty is actually between the United States and the United Kingdom and is titled *Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland (on behalf of the Government of Bermuda) relating to the Taxation of Insurance Enterprises and Mutual Assistance in Tax Matters.*

[92] See Joint Committee on Taxation, Prepared Statement of H. Patrick Oglesby, Foreign Tax Counsel, Alan L. Fischl, Legislation Attorney, and Stephen M. Parks, Accountant, Staff of the Joint Committee on Taxation Hearing on Proposed Tax Treaty With Bermuda Before the Senate Committee on Foreign Relations, September 25, 1986 (JCX-26-86), September 24, 1986 ("JCT 1986 Statement"). While Article 5 of that treaty provides in summary form for mutual assistance in tax matters and Article 6 for confidentiality relating to such matters, and an exchange of notes provided substantial details in these areas, in 1988 the United States and Bermuda entered into a more complete agreement for the exchange of tax information, titled Agreement between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland (on behalf of the Government of Bermuda) for the Exchange of Information with Respect to Taxes. These two treaties with the United States are the only tax treaties that Bermuda currently has in force. The U.S.-Bermuda tax treaty, like most U.S. tax treaties, contains anti-treaty-shopping rules intended to prevent residents of third countries from receiving benefits under the treaty. Unlike most U.S. tax treaties, however, the U.S.-Bermuda treaty's anti-treaty-shopping rules do not disqualify Bermuda companies from benefits on the basis of substantial U.S. ownership. This raises the question whether a U.S. tax treaty should provide an incentive to U.S. persons to locate their businesses outside the United States in order to obtain U.S. tax treaty benefits. Ibid. at 4. The U.S.-Barbados tax treaty, which the JCT 1986 Statement compared with the U.S.-Bermuda tax treaty, was amended by a protocol in 2004. Ibid. at 5.

[93] In combination with terminating the U.S.-Bermuda insurance tax treaty, this regulation could be overridden by new legislation and withholding could be imposed upon payments of reinsurance premiums to Bermuda reinsurers in lieu of imposing the section 4371 excise tax. A key economic question would be to determine an appropriate rate of withholding (between the one-percent excise tax rate and the 30-percent withholding tax rate) that would fairly tax the reinsurers' profits from insuring U.S. risks. In connection with these more significant changes, it would be desirable or necessary to consider the interaction of such withholding rules with other treaties and to equalize the treatment of Bermuda and other foreign reinsurers. Alternatively, different withholding rates could be applied to short-tail versus long-tail coverage. However, this approach could be quite complex in practice.

earnings shifted to a foreign reinsurer are not subject to U.S. tax.[94] On the other hand, the excise tax could be criticized as relatively arbitrary and not finely calibrated enough to serve as a proxy for U.S. income tax on earnings shifted offshore.

Economic family doctrine

Another approach is suggested by a doctrine advanced by the government in several cases involving premium deductibility in captive insurance arrangements, the economic family doctrine. Under this doctrine, the insuring parent corporation and its domestic subsidiaries, and the wholly owned insurance subsidiary, though separate corporate entities, represent one economic family with the result that those who bear the ultimate economic burden of loss are the same persons who suffer the loss.[95] Although the economic family doctrine was not adopted by courts in the absence of any legislative rule imposing it, it may nevertheless represent an analysis under which related party reinsurance premiums could be addressed by statute. In taking such an approach, consideration could be given to the percentage of ownership of affiliates, by vote, value, and in terms of practical business control, that should constitute an economic family. Other aspects of the analysis would involve a determination of the percentages of affiliated and third-party reinsurance, respectively, that would cause premiums paid to a member of the economic family not to be deductible, and whether imposition of tax in the affiliate's jurisdiction of incorporation is relevant.

Competitiveness

Advocates of making a legislative change to the tax treatment of offshore affiliate reinsurance assert that the current tax rules deliver a competitive disadvantage to U.S. insurers and reinsurers in an affiliated group with a U.S. parent. Current tax rules require U.S-based reinsurers to include earnings on reserve assets in their income for Federal tax purposes, while foreign-based reinsurers that are part of an affiliated group with a foreign parent are not subject to Federal tax on such earnings. Depending on the foreign income tax rules that apply to the offshore reinsurer, it is possible that little or no income tax may be paid with respect to earnings that, in the United States, are subject to regular corporate tax. Based on one calculation of

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[94] As in the case of withholding taxes, it would be important to address the effects of any such changes on U.S. trade agreements. Further, some tax treaties provide an exemption for the reinsurance excise tax, as described in part III of this document.

[95] Rev. Rul. 77-316, 1977-2 C.B. 53, *obsoleted by* Rev. Rul. 2001-31, 2001-1 C.B. 1348. The Internal Revenue Service announced in Rev. Rul. 2001-31 that it would not raise the economic family theory in determining whether payments between related parties are deductible insurance premiums. The deductibility of premiums paid by an insurer for reinsurance of 90 percent of its business with a Bermuda affiliate was successfully challenged by the IRS in *Carnation Co. v. Commissioner*, 71 T.C. 400 (1978), *aff'd*, 640 F. 2d 1010 (9th Cir. 1981), *cert. denied*, 454 U.S. 965 (1981). However, in a number of subsequent cases involving related party insurance or reinsurance in parent-subsidiary or brother-sister corporate structures, courts did not adopt the economic family theory. *See Clougherty Packing Co. v. Commisioner*, 84 T.C. 948 (1985), *aff'd*, 811 F.2d 1297 (9th Cir 1986); *Humana Inc. v. Commissioner*, 88 T.C. 197 (1987), *aff'd, rev'd, and rem'd,* 881 F.2d 247 (6th Cir. 1989); *Malone & Hyde v. Commissioner*, T.C.M. 1989-604, T.C.M. 1993-585, *rev'd*, 62 F.3d 835 (6th Cir. 1995); *Hospital Corp. of America v. Commissioner*, T.C.M. 1997-482 (1997); *Kidde Industries, Inc. v. U.S.*, 40 Fed. Cl. 42 (1997), *dismissed*, 194 F.3d 1330 (Fed. Cir. 1999).

market share, offshore reinsurers accounted for 58.6 percent of the reinsurance of U.S. risks for 2008, compared to U.S. reinsurers which accounted for 41.4 percent. In 1998, offshore reinsurers accounted for only 40.5 percent of reinsurance of U.S. risks.[96] Thus, it is argued, market share of offshore reinsurers of U.S. risks has grown at the expense of U.S. competitors.

On the other hand, it can be argued that the tax treatment is not the only determining factor, and that this increase in market share of foreign reinsurers did not coincide with any significant change in the tax treatment of either foreign or domestic reinsurers. Further, the reinsurance excise tax generally continues to apply,[97] so that foreign reinsurers cannot avoid paying at least some U.S. tax. If the foreign reinsurer has an economic loss with respect to reinsured U.S. risks, it is not able to deduct that loss for U.S. income tax purposes (suggesting that the offshore affiliate reinsurance is not tax-motivated), whereas a U.S. insurer or reinsurer may deduct such a loss. Changing the tax rules applicable to foreign reinsurers may not be appropriate, it is argued, because a tax change could hamper reinsurers' ability to manage capital and engage in risk shifting and risk distribution that is fundamental to the global insurance market.

Nondiscrimination under U.S. income tax treaties

Nondiscrimination articles of U.S. tax treaties generally prohibit nationals of one treaty country from being subjected to more burdensome taxation (or any connected requirement) in the other treaty country than are nationals of that other treaty country in the same circumstances. Proponents assert that the legislative proposals do not violate any nondiscrimination article of any applicable U.S. tax treaty.

Some may argue that recent legislative proposals violate these treaty requirements by denying deductions to U.S. affiliates of foreign companies when they reinsure with their foreign affiliates, but not applying a comparable deduction disallowance rule to U.S. companies reinsuring with their U.S. affiliates. Others may respond that the proposals do not violate any nondiscrimination article of any applicable U.S. tax treaty because both H.R. 3424 and the Administration budget proposal provide an election for affiliated foreign reinsurers to be subject to U.S. tax on premiums and net investment income that is associated with affiliated reinsurance transactions. By making this election, any foreign reinsurance company can insure that it is treated at least as well as any U.S. insurance company.

In addition, U.S. tax treaties generally provide that the nondiscrimination article does not apply in certain cases involving transactions between related persons. One of these circumstances arises in cases in which paragraph 1 of Article 9 (Associated Enterprises) of a U.S. tax treaty applies. That paragraph applies in cases in which an enterprise of a treaty country

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[96] Reinsurance Association of America, *Offshore Reinsurance in the U.S. Market*, 2008 Data, 13. In discussing different methods of computing market share, this publication states, at 12, "both methods confirm that the participation of offshore companies in the U.S. reinsurance market has grown over the past few years."

[97] As described above, the United States has entered into several tax treaties that provide an exemption from the insurance and reinsurance excise tax.

is related to an enterprise of the other treaty country, and there are arrangements or conditions imposed between the enterprises in their commercial or financial relations that are different from those that would have existed in the absence of the relationship.[98] The proposals set forth a standard for determining reinsurance premiums in an arm's-length fashion. Thus, any reinsurance premiums that are disallowed under the proposals do not, by definition, satisfy the arm's-length standard and may properly be disallowed under U.S. tax treaties.[99]

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[98] United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, Art. 24, par. 4; Art. 9, par. 1.

[99] In a related vein, under principles relating to trade rather than purely to tax policy, it is argued that the proposals may violate Article XVII of the World Trade Organization General Agreement on Trade in Services (GATS), relating to national treatment. See Gary Clyde Hufbauer, "Protection by Stealth: Using the Tax Law to Discriminate against Foreign Insurance Companies," *Peterson Institute for International Economics* Policy Brief No. PB810-9, April, 2010 On the other hand, it may be argued that the proposals do not violate the GATS national treatment Article because, for example, they (1) are direct tax measures, and (2) are based on objective criteria regarding the deductibility of payments that erode the U.S. tax base. Trade issues are beyond the purview of this document.