Director General

To: The Honorable Max Baucus
Chair, Senate Finance Committee
US Senate
511 Hart Senate Office Building
Washington, DC 20510
United States

Our reference: (MK) 14-001

Subject: Insurance Europe comments on the Senate's Finance Committee tax reform discussion draft disallowing tax deduction of affiliated reinsurance premiums.

Brussels, 17 January 2014

Dear Chairman Baucus,

Insurance Europe would like to share its comments on the Senate's Finance Committee tax reform discussion draft, which are as follows.

I. Executive summary

Insurance Europe, the European insurance and reinsurance federation, through its 34 member bodies — the national insurance associations — represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs that account for around 95% of total European premium income The European insurance industry is the largest in the world, making a major contribution to Europe's economic growth and development. European insurers generate premium income of more than €1 100bn, employ almost one million people and invest almost €8 500bn in the economy.

Foreign (re)insurers play an important role in the US market. A substantial part of US demand for insurance — more than 15% of direct insurance and more than 50% of the reinsurance accepted in 2011[1] — is provided by foreign insurers. For certain states and areas this figure is much higher; for example over 90% of reinsurance for Florida property insurance is provided by reinsurance companies located in foreign countries[2] .

Insurance Europe welcomes the opportunity to comment on the Senate Finance Committee international tax reform discussion draft and, in particular, the proposal to deny US tax deductions on reinsurance cessions to affiliated reinsurance companies located outside the US.

Insurance Europe believes that if this proposal were to be implemented it would severely affect the US insurance market and ultimately result in higher premiums and reduced availability of certain types of cover for US consumers. In addition, as a result of the proposal's discriminatory nature, it would place the US in breach of its international commitments; both at the WTO and with respect to the Double Taxation Agreements concluded between the US and EU member states.

[1] OECD Insurance Statistics; Edition 2011
[2] FL Citizens, Dowling & Partners Securities, LLC: IBNR Weekly September 20, 2012

Michaela Koller • Director General
Insurance Europe aisbl • rue Montoyer 51, B-1000 Brussels
Tel: +32 2 894 30 12 • Fax: +32 2 894 30 01
E-mail: koller@insuranceeurope.eu
www.insuranceeurope.eu

We understand that the rationale for the proposal is to reduce the incentive for non-US reinsurance companies to shift earnings from the US to jurisdictions where these earnings may be subject to very low or no income taxation. However, given that the proposal applies regardless of the tax jurisdiction in which the affiliated foreign company operates, it penalises EU reinsurers who are currently subject to statutory tax rate of on average 23%[3]. In addition, European insurance companies already comply with transfer pricing rules designed to attain the same goal as the proposal at stake.

Finally, the domestic election method contained in the proposal continues to discriminate against non-US reinsurers and, as such, continues to leave the US in breach of its international commitments to the WTO and its tax treaty partners. In addition, we believe the compliance costs associated with the election method will only serve to further discriminate against non-US (re)insurers.

II. Negative impact on US economy and consumers

It is important to underline that no major reinsurer exists on a purely regional or national basis; all major reinsurers are global businesses with a broad diversification of risk. Affiliated reinsurance is used to diversify risks. Transferring variable and uncorrelated risks to a central place, as is done via affiliated reinsurance, is necessary to maximise diversification benefits and smooth expected losses. Therefore, affiliated reinsurance plays an important role in increasing insurance capacity, in particular in areas prone to low-frequency, high-exposure risks such as hurricanes, earthquakes and terrorism.

Foreign (re)insurers play an important role in the US market. A substantial part of US demand for insurance — more than 15% of direct insurance and more than 50% of the reinsurance accepted in 2011 — is provided by foreign insurers. For certain states and areas this figure is much higher; for example over 90% of reinsurance for Florida property insurance is provided by reinsurance companies located in foreign countries.

Disallowing the premium deduction of affiliated foreign reinsurance would increase the costs of European (re)insurers active in the US. As a result, the efficient functioning of the US (re)insurance market would be distorted and lead to reduced capacity and competitiveness. Ultimately it would result in significant negative effects for US economy and consumers due to:

- More expensive insurance premiums: If foreign insurers are not allowed to reinsure with their affiliates, the available capacity in the reinsurance market will decrease and prices for reinsurance will increase. As a result, the insurance premium prices paid by US consumers will be substantially higher. Estimations based on a 2010 House of Representatives bill (H.R. 3424), identical to the proposal, show that insurance prices would increase by as much as 9% in some lines of business[4]. This would cost consumers billions per year and place a particular burden on disaster-prone states.
- Reduced capacity for disaster cover: European insurers provide a vital share of US catastrophe (re)insurance. Two thirds of the reinsurance for protection of US homes and businesses against hurricanes and earthquakes is provided by non-US reinsurers. Foreign (re)insurers paid more than 60% of the claims after the 2005 hurricanes (Katrina, Rita and Wilma) and the 11 September 2001 tragedy[5].
- Increased concentration risk: If additional costs are placed on the conduct of affiliate transactions, insurers will be discouraged from diversifying their risk, resulting in increased concentration risk in the US insurance market.

---

[3] http://www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx
[4] Brattle Group Report "The Impact on the U.S. Insurance Market of H.R. 3424 on Offshore Affiliate Reinsurance: An Updated Economic Analysis", July, 2010.
[5] J. David Cummins, The Bermuda Insurance Market: An Economic Analysis, May 6, 2008

III. Violation of US WTO obligations

The proposal treats foreign-based reinsurers in a discriminatory way by introducing a tax regime that would penalise foreign-owned US insurance companies that reinsure their risk with affiliated foreign companies. At the same time, the proposal does not apply to US-based reinsurers. If implemented, the proposal would constitute a breach of the US obligations under the WTO, in particular Art. XVII of the WTO General Agreement on Trade in Services (GATS).

Art. XVII (National treatment) provides for a national treatment obligation for all services for which members have undertaken specific commitments. The US schedule of specific commitments provides for national treatment for the cross-border provisions of reinsurance services, except that *"a one percent federal excise tax is imposed on all premiums covering US risks that are paid to companies not incorporated under US law, except for premiums that are earned by such companies through an office or dependent agent in the US"*. Except for this excise tax, the conditions of operation in the US for US and foreign companies should be the same.

Furthermore, the proposal does not fit within the exception from national treatment obligations in the GATS for direct taxes that safeguard the tax base (Article XIV), because it is unnecessarily punitive against foreign reinsurers, unjustifiably restricts competition and protects domestic service providers. The proposal does not distinguish between normal risk management practices used by all insurance companies and inappropriate, tax-motivated behaviour.

IV. Violation of double tax agreements

Insurance Europe stresses that the proposal, by limiting the deductibility of net insurance premiums paid to non-US affiliates, would breach the non-discrimination principle included in the US double tax agreements.

In particular, the proposal violates the non-discrimination principle stated in Art. 24 of the OECD Model Double Tax Model Convention signed between the US and the EU countries.

According to Art. 24, paragraph 2 of the OECD Convention, an affiliate of a foreign enterprise in the US shall not be taxed more unfavourably than a US enterprise. Paragraph 3 indicates that disbursements to a resident in the other contracting state shall be deductible when determining the taxable profits to the same extent as disbursements paid to a resident. Finally, paragraph 4 states that a company whose capital is wholly or partially owned or controlled by residents of a foreign state should not be subjected to more burdensome taxation than similar US companies.

As a result, the proposal clearly violates the US obligations under double tax agreements.

V. Transfer pricing rules in place

The problems this proposal seeks to address are normally resolved by applying transfer pricing rules. In reinsurance, US law accords the Treasury specific authority to address transfer pricing concerns involving related insurance and reinsurance companies and this should be sufficient to combat possible abuse in this area.

The transfer pricing rules of US Internal Revenue Code § 482 empower the IRS to make adjustments necessary to prevent tax evasion or more clearly reflect income earned by US companies. In addition, the special rules of US Internal Revenue Code § 845 on related-party reinsurance allow the IRS to make adjustments to fully reflect the income of the US insurance company. In the American Jobs Creation Act of 2004, these related-party reinsurance rules were amended to further strengthen the IRS's authority to enforce arm's-length pricing in affiliate reinsurance contracts.

If there are concerns that certain non-US reinsurers are not complying with US transfer pricing rules the US tax administration should challenge those companies through transfer pricing audits. It is inappropriate to subject all affiliated reinsurance income to full US taxation as an alternative to conducting such audits.

VI. The election method

The proposal allows non-US reinsurers to continue with the tax deduction if they elect to be subject to US taxation (the domestic election)[6].
In Insurance Europe's view, the election method does not solve the challenges of discriminatory treatment of European (re)insurers posed by violation of US double taxation and trade obligations. At the same time, complying with the election method would increase the compliance burden for non-US (re)insurers doing business in the US.

Double taxation
First, in Insurance Europe's view, the election method does not solve the challenges of the OECD Double Taxation Convention. Specifically, this method ignores Art. 7 of the OECD Model Convention, which is of central importance to the avoidance of double taxation in the international taxation of business profits. Art. 7 states that "an enterprise of one State shall not be taxed in another State unless it carries on business in that other State through a permanent establishment".

If a foreign corporation has no permanent establishment in the US, within the meaning of Art. 5 of the OECD Model Convention, the right to tax business profits (e.g. reinsurance premiums) is allocated exclusively to the state of residence of the foreign company. Even if a foreign company has permanent establishment in the US, the second principle reflected in Art. 7, states that the US right to tax does not extend to profits (eg reinsurance premiums) that the foreign company may derive from the US but that are not attributable to the permanent establishment.

Furthermore, the domestic election will likely result in double taxation because of the foreign tax credit utilisation rules of European countries. Double taxation may arise on the relevant business, when the non-US reinsurer, taxed on its global risks and not merely its US risks in its state of operation, has tax losses resulting from large insurance claims or large reserve increases arising outside the US. This would give rise to double taxation, with non-US insurers compelled to pay US taxes even though the company has a net operating loss.
The ability to use such US taxes as offsets against European tax may be deferred to periods when the foreign taxes may expire as potential credits.

Trade obligations
Secondly, in Insurance Europe's view, the election method is incompatible with US GATS obligations.

Under the GATS market access provisions (Art. XVI (1)), the US committed to accord foreign-based reinsurance service suppliers of any other member a treatment that is no less favourable than that provided for under the terms, limitations and conditions agreed and specified in its Schedule. In particular, according to Art. XVI (2)(e) *"[i]n sectors where market-access commitments are undertaken, the measures which a Member shall not maintain or adopt, … unless otherwise specified in its Schedule, are defined as… measures which restrict or require specific types of legal entity… through which a service supplier may supply a service."*

However, because of the punitive nature of the main provision, there would be no other choice than to use the election, making it a forced conversion to treatment as a US entity. This would be a clear violation of the US obligations under GATS.

[6] The proposal allows the tax deduction to continue only if the foreign reinsurers elect to be subject to US tax, ie if the foreign reinsurers treat those premiums and the associated investment income as income effectively connected with the conduct of a trade or business in the US and attributable to a permanent establishment in the US for tax treaty purposes.

Increased administrative burden
Finally, the domestic election method places an unparalleled administrative burden on European insurance companies.

As domestic companies do not face similar administrative costs, the proposed tax credit method discriminates against European insurance companies operating in the US in two ways.

First, in order to calculate the tax credit, the European insurance company would monitor and handle two parallel tax assessments: one in its own jurisdiction and another one in the US.

Second, even if the European insurance company elects to treat those premiums and the associated investment income as income effectively connected and attributable to a permanent establishment in the US, ring-fencing the underlying investment income would be impractical and impossible to achieve due to different local assessment rules.

VII. Conclusions

Insurance Europe believes that if the proposals were to be implemented they would negatively affect US economy and consumers and place the US in breach of its international commitments. The domestic election method contained in the proposal continues to discriminate against non-US reinsurers, while introducing a new reporting and compliance burden. Therefore, Insurance Europe remains strongly opposed to the introduction of the proposal to limit the deductibility of non-US affiliate transactions as included in the draft Senate tax reform bill.

Yours sincerely,

Michaela Koller
Director General