# A LEVEL PLAYING FIELD

*An increase in the excise tax would place domestic reinsurers on a more level playing field with their foreign competitors.*

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A proposed increase in the federal excise tax on reinsurance premiums paid to foreign reinsurers is the subject of heated debate among property/casualty insurers and reinsurers. The proposal arose in the wake of major tax reform in 1986, which imposed substantial new tax burdens on domestic reinsurers. Now the issue has taken on added urgency because a bill to increase the tax in a limited form was introduced in 1992, and it is anticipated the new Congress will take further action.

In its current form, the issue pits nonresident reinsurers and the domestic primary industry against the domestic reinsurance industry. Nonresident reinsurers and domestic insurers allege that if the FET is increased, the cost of reinsurance coverage will rise, and many of our trading partners will retaliate with tax measures of their own. On the other hand, some domestic reinsurers, which are subject to U.S. corporate taxes, are calling for a level playing field to compensate for the 1986 loss-reserve discounting rules.

The issue also is becoming more important because the migration of reinsurance premium overseas is increasing. Ac-

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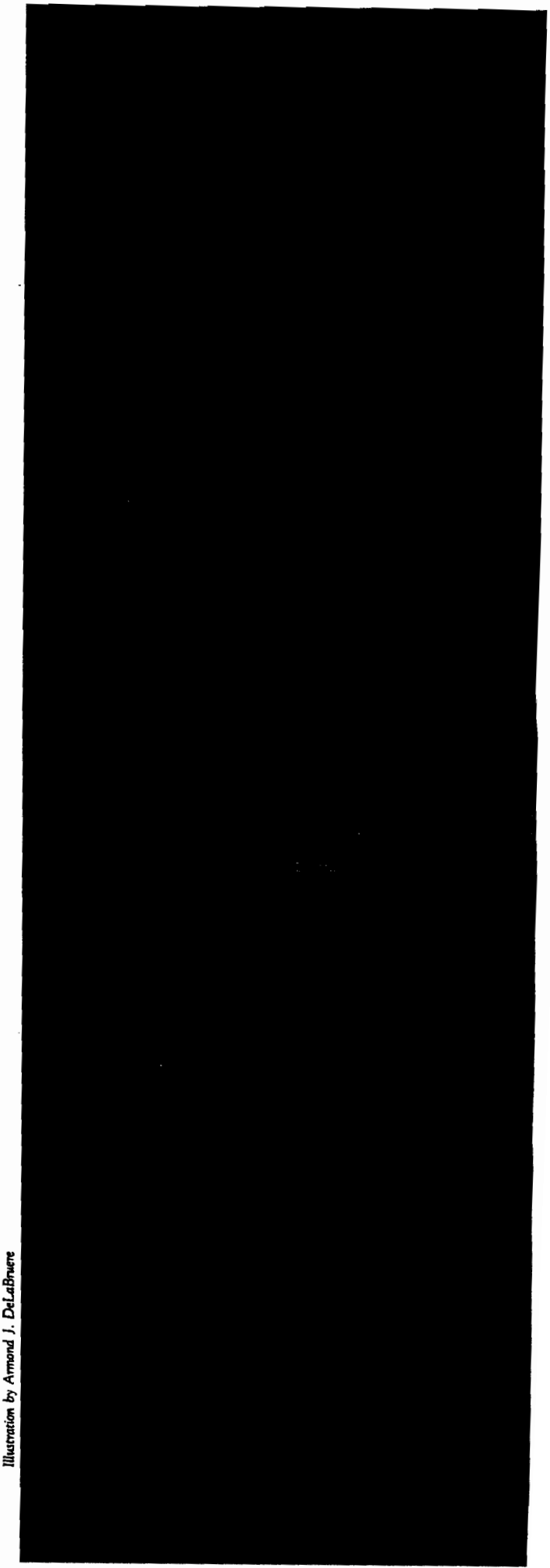

*Illustration by Armond J. DeLaBruere*

cording to the U.S. Department of Commerce, the foreign share of the domestic reinsurance market was approximately $10.3 billion in 1991 (up from $9.1 billion in 1990, $8.8 billion in 1989 and $7.8 billion in 1988). This compares with 1982, when the foreign share was $2.5 billion. In particular, Bermuda, which does not impose tax on any insurance transactions, has enjoyed a surge in the volume of its U.S. risk reinsurance transactions, which rose from $960 million in 1982 to approximately $3.4 billion in 1991.

Accelerating migration of premiums overseas demonstrates the consequences of the increased tax burden borne only by resident reinsurers. To help put alien and domestic reinsurers on an equal competitive footing once again, the property/casualty reinsurance excise tax would have to be increased from 1% to at least 4% on reinsurance transactions, at least with companies that are resident in tax-haven countries.

### *A LOW RATE*

Under Internal Revenue Code section 4371, all policies of insurance, indemnity bonds, annuity contracts and policies of reinsurance issued by any alien insurer or reinsurer are subject to an excise tax, unless the income of the insurer or reinsurer is subject to taxation as income "effectively connected with a U.S. trade or business." The tax rate is 4% for direct property/casualty premiums and indemnity bonds, but only 1% for reinsurance contracts covering U.S. risks.

The legislative antecedent to this taxation scheme for reinsurance cessions to foreign companies is linked most directly and historically to provisions in the Revenue Act of 1942. Prior to passage of this act, reinsurance as a distinct contract of insurance was exempt (by omission) from taxation in all revenue acts by Congress. This exemption was based primarily on the theory that a new insurance policy is not issued in a reinsurance arrangement. However, in 1942 the federal taxation status of alien reinsurance companies changed drastically when Congress imposed an excise tax on policies of reinsurance written by alien reinsurers. By adding the taxation of reinsurance premiums paid to alien insurers and reinsurers, legislators clearly demonstrated that they wanted to eliminate unwarranted competitive advantages for these foreign companies.

This same competitive imbalance has resurfaced for domestic property/casualty reinsurers with the enactment of loss-reserve discounting rules in the Tax Reform Act of 1986. Prior to the act, the effective federal tax burden on U.S. reinsurers was negligible. In fact, in 1984 when the Senate Finance Committee voted on a proposed increase in the reinsurance excise tax from 1% to 4%, the Reinsurance Association of America urged that it be rejected because the increase would unfairly tilt reinsurance competition toward U.S. interests.

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But the far-reaching tax bill of 1986 dramatically altered the world marketplace for reinsurance. By requiring insurers to discount loss reserves prior to calculating their federal tax liabilities, TRA 1986 created a significant—and previously unknown—tax burden on U.S. reinsurers, particularly companies writing long-tailed casualty lines in which the discount cut the deepest. Because no similar burden was placed on alien reinsurers without an established U.S. presence, some in the domestic reinsurance industry balked.

Soon after enactment of TRA 1986, the RAA called for legislation to increase the reinsurance excise tax from 1% to 4%, the same rate applied to direct insurance premiums paid to alien insurers. In addition, the RAA supported the elimination of all provisions to waive the imposition of the reinsurance excise tax in bilateral income tax treaties.

### *INCREASE SUPPORTED*

In support of the proposed increase, the RAA pointed to a tax model prepared to analyze the effects of TRA 1986. Based on conservative assumptions, the study indicated that the loss-reserve discounting rule would require domestic reinsurers to increase premiums at least 7% to offset additional tax liabilities resulting from the rule, or suffer a possible 16% decline in profitability.

Other studies supported these conclusions. The insurance actuarial and consulting firm Tillinghast reported that the tax impact of the 1986 act could require domestic reinsurers' prices to go up "a minimum of 4% to 10% just to stay even" and indicated

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the act would give non-U.S. jurisdictions "a very real competitive advantage." And in its 1989 survey of the effect of the 1986 act, the accounting firm Price Waterhouse concluded that in the first year after the act's passage, the loss-reserve discounting rule caused an increase of almost $1 billion in the income tax burden of the domestic property/casualty insurance industry and that the domestic reinsurance industry was hardest hit. Standard & Poor's reported that resident U.S. reinsurers had a 1991 effective tax rate of 29.5% and paid federal income taxes that "far exceed initial estimates made by the General Accounting Office when TRA 1986 became law."

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Finally, in 1990 the Treasury Department released a report to Congress on the effect on U.S. reinsurers of waiving excise taxes by treaty. The report demonstrates conclusively that "nonresident reinsurers located in countries which do not impose a material level of tax on U.S. risk reinsurance premiums have a significant competitive advantage over U.S. reinsurance companies, if the excise tax imposed on such premiums is waived by treaty."

### *"ANTICONDUIT" PROVISION*

Currently, many of the nation's trading partners are parties to income tax treaties that include such premium excise-tax waivers. These countries include France, Germany, Italy, Spain, Finland and the United Kingdom. In addition, the model U.S. income tax treaty, upon which most of these treaties are based, contains a similar waiver, which is not available if the insurer or reinsurer reinsures the subject U.S. risks with a company located in a country that is not entitled to the benefits of a U.S. income tax treaty waiver. The treaty clause that creates this condition in the majority of treaties with an excise tax waiver is known as an "anticonduit" provision.

The report strongly recommends that any treaty waiver of the excise tax should include an anticonduit provision, stating that the need for such a provision is "self-evident" because, without it, "a company established in a treaty jurisdiction that benefits from the waiver could receive an exempt premium from the United States and immediately reinsure the risk with a company in a nonexempt country."

The most recent proposal for increasing the excise tax—H.R. 5270, the Foreign Income Tax Rationalization and Simplification Act of 1992—was introduced May 27, 1992, by House Ways and Means Committee Chairman Dan Rostenkowski (D-Ill.) and former Rep. Willis Gradison (R-Ohio). The bill would have amended section 4371 of the U.S. Tax Code by increasing the excise tax from 1% to 4% on property/casualty premiums paid to alien reinsurers in low-tax countries. The increase in the excise tax on alien reinsurers would not apply if the reinsurer were a resident of a foreign country that imposed a "substantial" effective tax rate in relation to the U.S. tax on similar reinsurance transactions—and if the risks were not subsequently reinsured with a company resident in a country that did not impose an effective tax rate that is also "substantial" in relation to the rate imposed on U.S. companies. In addition, the bill would have authorized the secretary of the treasury to promulgate regulations to enforce these changes.

While H.R. 5270 was making its way through Congress, Sen. John B. Breaux (D-La.) offered an amendment to H.R. 776, the House energy bill, that was identical to the excise-tax provision of H.R. 5270. The Senate approved the amendment, and a conference of House and Senate members considered the entire energy bill.

Following meetings between former Sen. Lloyd Bentsen (D-Tex.), chairman of the Senate Finance Committee, and Rep. Rostenkowski, a compromise version of the energy bill—from which the excise tax was deleted—was submitted to Congress. Reportedly, Chairman Rostenkowski was opposed to including the increase in the excise tax in H.R. 776 because he wanted to retain it for H.R. 5270, in which it represented a significant revenue-raising measure. Further action on the foreign tax provisions addressed in H.R. 5270 is expected in the 103rd Congress.

### *CORRECTING INEQUITIES*

Consistent with the findings of the Treasury report in 1990, both H.R. 5270 and H.R. 776 would have applied the increase in the reinsurance excise tax only to those countries that did not impose a "substantial" tax on their resident companies. The Joint Committee on Taxation staff explained the term "substantial" to mean that the increase in the excise tax on reinsurance premiums would apply only to residents of foreign countries that are subject to an effective tax rate of less than 50% of the applicable U.S. effective tax rate.

This increase in the excise tax, although limited, to low-tax countries, would represent a substantial correction of the inequities caused, in part, by the 1986 act. And, although a 3% increase in the tax does not achieve the level playing field estimated in the RAA model, which requires a 7% rise, the increase to 4% would match the excise tax rate currently assessed by the United States on gross direct premium on property and casualty business written by nonadmitted alien insurers.

Critics of the increase in the excise tax have minimized the effect of the violation of the anticonduit concept by alleging that some "leakage" of treaty benefits does not detract from the validity of the policy. However, the increased migration of treaty benefits to tax-haven countries shows that the leakage has grown to near-flood proportions. According to data compiled from the National Association of Insurance Commissioners' annual statement database, in 1990 nonresident reinsurers accounted for more than 40% of the domestic reinsurance market. The 1990 annual statement data analysis, performed by the Insurance Services Office on behalf of the RAA, revealed that 1,396 unaffiliated nonresident reinsurers received ceded premium of $5.15 billion. The principal markets for this ceded premium were the United Kingdom, $1.945 billion;

Bermuda, $1.027 billion; Germany, $318 million; Barbados, $250 million; Canada, $208 million; and the Cayman Islands, $161 million.

Nonresident reinsurers affiliated with U.S. insurers, which included 171 companies in 30 countries, received premiums of $1.68 billion from their U.S. affiliates in 1990. The principal countries receiving this premium were Bermuda, $1.003 billion; Switzerland, $134 million; Sweden, $126 million; Barbados, $113 million; and Germany, $76 million.

While alien reinsurers play an important role in providing capital to support the U.S. risk reinsurance market, the 1990 annual statement data analysis shows that a vast majority of premiums ceded from resident insurers to both unaffiliated and affiliated nonresident reinsurers goes to countries such as Bermuda, Barbados and the Cayman Islands. These countries boast large international financial communities primarily because they lack a corporate taxation scheme and have a relaxed, if not nonexistent, regulatory environment. None of the Caribbean countries that appear among the 10 most active foreign reinsurance markets is known to have a "substantial" effective tax on insurance or reinsurance. It is within this world market place that resident U.S. reinsurance companies currently compete, burdened with comprehensive regulation, loss-reserve discounting and an otherwise substantial domestic corporate tax burden.

Yet some critics of increasing the excise tax claim that application of an anticonduit concept constitutes a treaty override and that enforcement of the rule is administratively burdensome. Specifically, in a letter to the Department of Treasury, the British Embassy complained that the excise tax proposal in H.R. 5270 effectively overrode the United States-United Kingdom treaty, which does not contain an explicit anticonduit rule. The Treasury Department acknowledged this concern in its testimony before the House Ways and Means Committee, but Fred T. Goldberg Jr., assistant secretary, said the department disagreed with Britain's conclusion regarding the proposal. Even an advocate for the British insurers noted that Treasury has demonstrated its concern about preventing treaty abuse that allows residents of a third country to take advantage of tax relief provided to residents of a treaty country.

Claims that an increase in the excise tax represents a large administrative burden (a position that has received some support from Treasury) seem exaggerated in comparison with the competitive disadvantage experienced by U.S. domestic companies. Although the provisions introduced in H.R. 5270 and H.R. 776 would require Treasury to enter into additional closing agreements, model closing agreements are available, along with revenue procedures that provide instructions for establishing exemptions from the excise tax.

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Critics also say the proposed increase in the reinsurance tax would lead to an increase in the cost of reinsurance worldwide. However, in his testimony on H.R. 5270 before the House Ways and Means Committee, Mr. Goldberg noted that the pricing of reinsurance is far too complex and includes too many variables to support the notion that an increase in the tax would automatically increase the cost of reinsurance.

In any event, to the extent that the cost of foreign reinsurance is increased, it is for the purpose of placing domestic reinsurers on a more level playing field with their foreign competitors—the field on which they should have been playing all along. If, in fact, the cost of foreign reinsurance is increased, it is because the U.S. government is currently subsidizing insurers that use offshore reinsurance. BR