Technical Explanation of Bill to Amend the Internal Revenue Code of 1986 to Prevent Avoidance of U.S. Tax Through Reinsurance with Nontaxed Affiliates

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.

Life insurance companies

For Federal income tax purposes, an insurance company is treated as a life insurance company if the sum of its (1) life insurance reserves and (2) unearned premiums and unpaid losses on noncancellable life, accident or health contracts not included in life insurance reserves, comprise more than 50 percent of its total reserves.[1]

Reserves

In determining life insurance company taxable income, a life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves.[2] Methods for determining reserves for tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under State regulatory rules.

Reinsurance premiums

A deduction is permitted for consideration − including reinsurance premiums − paid in respect of assumption of liabilities under insurance and annuity contracts.[3]

Proration of deductions for untaxed income

Because reserve increases might be viewed as being funded proportionately out of taxable and tax-exempt income, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest. Similarly, a life insurance company is allowed a dividends received deduction only in proportion to the company's share of such dividends. For this purpose, the policyholders' share

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[1] Sec. 816(a).

[2] Sec. 807.

[3] Sec. 805(a)(6).

of any item is 100 percent of the item reduced by the company's share of the item. The company's share is determined in relation to net investment income of the company.[4]

Property and casualty insurance companies

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.[5] For this purpose, underwriting income and investment income are generally computed on the basis of the underwriting and investment exhibit of the annual statement approved by the NAIC.[6]

Deduction for unpaid loss reserves

Underwriting income means premiums earned during the taxable year less losses incurred and expenses incurred.[7] 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). The deduction for loss reserves is discounted to take account partially of the time value of money.[8] Thus, the deduction for unpaid losses is limited 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 ("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.

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.[9]

Unearned premiums

Further, the company deducts from gross premiums the increase in unearned premiums for the year.[10] The company is required to reduce the deduction for increases in unearned

[4] Sec. 812.

[5] Sec. 832.

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

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

[8] Sec. 846.

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

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.[11] 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.

Treatment of reinsurance

In general

A rule enacted in 1984 provides authority to the Treasury Department to reallocate items and make adjustments in reinsurance transactions to prevent tax avoidance or evasion.[12]

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.[13] 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."[14]

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

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

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

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

[14] See Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress*, (JCS-5-05), May 2005, p. 351; Senate Finance Committee Report to S. 1637, Jumpstart Our Business Strength (JOBS) Act, S. Rep. No. 108-192, November 7, 2003, p.161.

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.[15]

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 tax credit

A foreign tax credit is provided for income and withholding taxes paid to a foreign country, to prevent taxation of the income both in the United States and in the other country.[16] The amount of the credit is subject to a foreign tax credit limitation, which provides generally that the credit is limited to the amount of the taxpayer's U.S. tax on foreign-source income. The foreign tax credit limitation is generally computed separately for income in two categories: passive and general. Excess credits may be carried back one year and forward 10 years.

Effectively connected income

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.[17] 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

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[15] Conference Report to H.R. 4170, The Deficit Reduction Act of 1984, H.R. Rep. No. 98-861, June 23, 1984, p. 1063-4. In *Trans City Life Insurance Company v. Commissioner*, 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.

[16] Secs. 901-909.

[17] Sec. 882.

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.[18]

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.[19] Special rules apply to calculate the minimum effectively connected net investment income for this purpose.[20]

30-percent gross basis withholding

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.[21]

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.[22] Under these rules (colloquially referred to as trading safe harbors), trading in stock, 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, 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, securities, or commodities.

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[18] Sec. 881.

[19] Sec. 842.

[20] Sec. 842(b). In *North West Life Assurance Co. of Canada v. Commissioner*, 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).

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

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

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.[23] Original issue discount on obligations maturing in six months or less is also exempt from tax.[24] An additional exception is provided for certain interest paid on portfolio obligations.[25] 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.[26] 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.[27] Moreover, this exception is not available for certain contingent interest payments.[28]

Subpart F

Under the subpart F rules,[29] 10-percent U.S. shareholders of a controlled foreign corporation are subject to U.S. tax currently on certain income earned by the controlled foreign corporation, 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 rules generally do not apply in the case of a foreign corporation that is controlled by foreign persons.

Active financing exception under subpart F

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").[30] In general, the availability of

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

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

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

[26] Sec. 871(h).

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

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

[29] Secs. 951-965.

[30] Secs. 953(e) and 954(h) and (i), which expires December 31, 2011.

the exception for income derived in the active conduct of a banking, financing, or similar business requires that the controlled foreign corporation 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.

Related person insurance income under subpart F

Special rules apply under subpart F with respect to related person insurance income.[31] Enacted in 1986, these rules address the concern that "the related person insurance income of many offshore 'captive' insurance companies avoided current taxation under the subpart F rules of prior law because, for example, the company's U.S. ownership was relatively dispersed."[32] For purposes of these rules, the U.S. ownership threshold for controlled foreign corporation status is reduced to 25 percent or more. Any U.S. person who owns or is considered to own any stock in a controlled foreign corporation, whatever the degree of ownership, is treated as a U.S. shareholder of such corporation for purposes of this 25-percent U.S. ownership threshold and exposed to current tax on the corporation's related person insurance income. Related person insurance income is defined for this purpose to mean any insurance income attributable to a policy of insurance or reinsurance with respect to which the primary insured is either a U.S. shareholder (within the meaning of the provision) in the foreign corporation receiving the income or a person related to such a shareholder.

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.[33] The branch level taxes are comparable to these second-level taxes. In addition, if 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

[31] Sec. 953(c).

[32] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87, May 4, 1987, p. 968.

[33] Sec. 884.

An excise tax applies to premiums paid to foreign insurers and reinsurers covering U.S. risks.[34] 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 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.[35]

Certain U.S. tax treaties provide an exemption from the excise tax, including the treaties with Germany, Switzerland, and the United Kingdom.[36] 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).[37]

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[34] Secs. 4371-4374.

[35] 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.

[36] 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.

[37] 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.

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.[38] 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, 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.[39]

Present law limits the ability of corporations to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions involving interest payments. 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).[40] 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. 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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[38] Pub. L. No. 100-647.

[39] 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, pp. 12-20, 22.

[40] Sec. 163(j).

Reasons for Change

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. There may also 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.

Another reason 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[41] to surplus. Reinsuring some of the company's risks can lower the ratio of net premiums to surplus and allow the company to write more insurance. Thus, reinsurance can serve in effect as a form of financing for growth in the primary insurance company's business.

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.

A reinsurance transaction can also 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.[42]

In addition to these reasons to engage in a reinsurance transaction, there may be particular reasons in the case of related party reinsurance. The transaction can serve to move capital within a group of related parties, or to consolidate capital in a central location to maximize its efficient management. Further, the parties may know more about each other and about the risks than in the case of unrelated parties, which can reduce the pricing of the reinsurance.

The related party reinsurance transaction can have U.S. tax benefits as well as book or financial benefits. In general, premiums ceded for reinsurance are deductible in determining a

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[41] 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. 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.

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

company's Federal income tax.[43] If the transaction effects a transfer of reserves and reserve assets to the reinsurer, the tax liability for earnings on those assets generally is shifted to the reinsurer as well. If earnings on these assets are shifted to a related foreign-owned reinsurer, the earnings generally are not subject to U.S. income taxation, and could be untaxed (if the related foreign reinsurer is in a no- or low-tax foreign jurisdiction).

The transfer of U.S. risks to foreign affiliates in low-tax or no-tax jurisdictions through reinsurance transactions has been criticized as causing a tax-induced competitive disadvantage for U.S.-owned insurers and reinsurers.[44] The issue has been publicized repeatedly in recent years[45] despite 2004 changes in the Federal tax law to limit the tax benefit of "inversions"[46] – expatriation of a U.S. corporation or partnership to a foreign jurisdiction – and to strengthen the Treasury Department's regulatory authority to reallocate items in related party reinsurance arrangements.[47] Though these changes may have made some types of transactions transferring

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

[44] See Jon Almeras and Ryan J. Donmoyer, "Insurers Approach Congress to Fix 'Bermuda Loophole,'" 86 *Tax Notes* 1660, Mar. 20, 2000; Lee A. Sheppard, "News Analysis – Would Imputed Income Prevent Escape to Bermuda?," 86 *Tax Notes* 1663, Mar. 20, 2000.

[45] Hearing of the Select Revenue Measures Subcommittee of the House Ways and Means Committee on tax issues relating to reinsurance transactions between affiliated entities on July 14, 2010; in connection with that hearing, see 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. Hearing of the Senate Committee on Finance, "Offshore Tax Issues: Reinsurance and Hedge Funds," September 26, 2007, Testimony of William R. Berkley, Chairman and CEO, W.R. Berkley Corporation: "Current law allows a U.S. member of a foreign–domiciled group to avoid paying U.S. tax on much of its domestic underwriting and investment income, merely by reinsuring its business with a related-party reinsurer domiciled in a country such as Bermuda or the Cayman Islands. By contrast, a U.S.-based insurance group must pay U.S. tax on all of its underwriting and investment income derived from writing similar domestic business." http://finance.senate.gov/sitepages/hearing092607.htm. See also Susanne Sclafane, "U.S. CEO on a Mission to Tax Bermuda Competitors," *National Underwriter Online News Service*, Nov. 20, 2006; Susanne Sclafane, "Bermuda CEO Fights Back on Tax Issue," *National Underwriter Online News Service*, Nov. 21, 2006. In 2002, in oral testimony before the Ways and Means Committee and in written response to a question, Pamela Olson, Acting Assistant Treasury Secretary for Tax Policy, stated, "The Treasury Department is concerned about the use of related party reinsurance to avoid U.S. tax on U.S.-source income. In particular, the use of related party insurance may permit the shifting of income from U.S. members of a corporate group to a foreign affiliate. Existing mechanisms for dealing with insurance transaction [sic] are not sufficient to address this situation." Hearing of the House Committee on Ways and Means on Corporate Inversions, June 6, 2002, Serial 107-73, pages 9-10 and 26, http://waysandmeans.house.gov/legacy.asp?file=legacy/fullcomm/107cong/6-6-02/107-73final.htm.

[46] Section 7874, imposing U.S. tax on certain income and gain of expatriated entities, was enacted in section 801 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357.

[47] Section 845, providing authority to the Treasury Department for allocation in the case of a reinsurance agreement involving tax avoidance or evasion, was enacted in 1984 and was modified by section 803 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357.

U.S. risks to foreign reinsurers less attractive from a tax planning standpoint, reinsurance with offshore affiliates has remained strong.[48]

Insuring risks with insurance affiliates generally can have the effect of reducing U.S. tax on earnings on reserves set aside to cover losses incurred with respect to those risks. Because tax accounting rules applicable to insurance companies provide a deduction for additions to insurance reserves, investment earnings on insurance company reserves can be viewed as tax-favored.[49]

The bill reflects the concern that the use of affiliated reinsurers is a means by which U.S. insurance risks migrate to offshore reinsurance markets so as to avoid U.S. tax on reserve earnings. In response to this concern, the bill provides that the otherwise deductible amount of premiums for reinsurance with foreign affiliates (that is not taxed in the U.S.) is not deducted in determining the ceding insurer's U.S. income tax, nor are additional amounts paid by the insurer with respect to the reinsurance transaction. The bill also provides an exclusion from income for return premiums, ceding commissions, reinsurance recovered, or other amounts received by the insurer with respect to the nondeductible reinsurance premiums.

The bill is targeted to the problem of avoidance of U.S. tax on earnings shifted offshore through affiliate reinsurance. The bill achieves this targeting because the period of deduction disallowance is coordinated with the period of income tax avoidance. That is, the deduction is disallowed, but the disallowance is offset by the exclusion from the ceding company's income of ceding commissions, reinsurance recovered, return premiums, or other amounts (if any) with respect to the reinsurance when it receives them (to the extent these amounts are allocable to the nondeductible reinsurance premium). This approach acknowledges that reinsurance has essential risk management and other functions. At the same time, the approach is structured to discourage reinsurance transactions that are likely to be motivated by avoidance of U.S. taxation of income associated with insuring or reinsuring the risk.

The economic effect of the bill is generally that the ceding company is subject to U.S. tax on the earnings on the reinsurance premiums (or other amounts) for which the deduction is disallowed. The ceding company’s income is measured more accurately than would result by either allowing a current deduction, or by denying the deduction without a corresponding exclusion of amounts received by the ceding company with respect to the reinsurance transaction.

The bill also 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

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[48] Reinsurance Association of America, *Offshore Reinsurance in the U.S. Market: 2009 Data*, at Table 8 (stating that “[t]he NAIC database indicates that companies in 38 jurisdictions received reinsurance premiums of $34.5 billion from affiliated U.S. insurers in 2009….”). The comparable volume of affiliated offshore reinsurance premiums for 2004 was $31.1 billion. Reinsurance Association of America, *Offshore Reinsurance in the U.S. Market: 2008 Data*, at Table 8.

[49] Discounting rules applicable to tax reserves of property and casualty insurance companies partially take account of the time value of money (sec. 846).

transactions. This election is intended to provide another option to ensure that these foreign affiliates are not treated less favorably than U.S. reinsurers. Income treated as effectively connected under the election is treated as foreign source income and is placed in a separate category for purposes of the limitation on the foreign tax credit. The prohibition of cross-crediting achieved by creating a separate category or "basket" for this income for foreign tax credit limitation purposes tends to reduce the potential for tax abuse.

Explanation of Provision

General rule of nondeduction and noninclusion

Under the provision, the income of an insurance company is determined by not taking into account nontaxed reinsurance premiums. That is, the insurance company is not allowed a deduction for nontaxed reinsurance premiums paid. In addition, its income is determined by not taking into account (so no deduction is allowed for) any additional amount paid with respect to the reinsurance for which the nontaxed reinsurance premium is paid to the extent the additional amount is properly allocable to the premium. Finally, the insurance company's income is determined by not taking into account any return premium, ceding commission, reinsurance recovered or other amount received by the insurance company with respect to the reinsurance for which the nontaxed reinsurance premium is paid to the extent the item is properly allocable to the premium. Thus, these items of income (to the extent they arise with respect to reinsurance for which nontaxed reinsurance premiums were paid) generally are excluded from the insurance company's income. The provision applies in the case of reinsurance of risks other than life insurance, annuity, or noncancellable accident and health insurance risks.

The exclusion for the return premium, ceding commission, reinsurance recovered, or other amount received is allowed to the same extent that no deduction was allowed for the reinsurance premium paid (and for additional amounts paid by the insurance company with respect to the reinsurance with respect to which the premium was paid). The exclusion does not apply to any greater extent.

For example, if the amount of the reinsurance premium (and any additional amount) totaling 100 for which a deduction is not allowed is 80, then 80 percent of the total amount of the return premium, ceding commission, reinsurance recovered, and other amount received is excluded. Thus, if the total amount of the return premium, ceding commission, reinsurance recovered, and other amount received is 200, then 80 percent, or 160, may be excluded, and the balance is included in the company's income. It is intended that the Treasury Department provide prompt guidance as to the method of allocation among items of income, and in the absence of Treasury guidance, a pro rata allocation is the appropriate method (i.e., the same percentage of each item is excluded (80 percent of each item in the above example)).

Application to insurance companies

The provision applies to an insurance company for purposes of determining its taxable income under section 831 or its life insurance company taxable income under section 801 (to the extent the company pays reinsurance premiums with respect to risks other than life insurance, annuity, or noncancellable accident and health insurance risks). Thus, for example, a property and casualty insurance company subject to tax in the United States is subject to the provision with respect to reinsurance of risks other than life insurance, annuity, or noncancellable accident and health insurance risks. A life insurance company subject to tax in the United States is subject to the provision only with respect to reinsurance of risks other than life insurance, annuity, or noncancellable accident and health insurance risks. The fact that a company has no U.S. income tax liability for the taxable year (for example, due to losses) does not cause the company not to be considered as subject to the provision.

Nontaxed reinsurance premiums

A nontaxed reinsurance premium is any reinsurance premium paid directly or indirectly to an affiliated corporation with respect to certain contracts, to the extent that the income attributable to the premium is not subject to Federal income tax. Nontaxed reinsurance premiums do not include premiums for reinsurance with respect to any life insurance, annuity, or noncancellable accident and health insurance contract (including a life insurance or annuity contract combined with noncancellable accident and health insurance).[50] Thus, the risks to which the provision applies are property and casualty insurance risks, not life insurance risks. For purposes of the provision, the income is not subject to U.S. income tax if it is neither included in the income of the affiliated corporation, nor included in income by a United States shareholder under section 951 pursuant to the rules of subpart F.

The excise tax under section 4371 is disregarded for purposes of determining whether income attributable to the premium is subject to U.S. income taxation. 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 U.S. income tax as an insurance company, is not considered an affiliated corporation the income of which is subject to U.S. income taxation for purposes of this provision.

As a further example, assume that a controlled foreign corporation with a 15-percent minority interest held by persons that are not 10-percent U.S. shareholders receives a reinsurance premium. The 10-percent U.S. shareholders are subject to current U.S. income taxation on their shares of income attributable to the reinsurance premium, but the holders of the 15-percent minority interest are not. Assume further that the corporation is not subject to U.S. corporate income tax. Under these circumstances, 15 percent of the income attributable to the premium is not subject to U.S. income tax for purposes of the provision.

Affiliated corporation

For purposes of the provision, a corporation is treated as affiliated with an insurance company if both corporations would be treated as members of the same controlled group of corporations under section 1563(a), but applying a standard of at least 50 percent (rather than at least 80 percent) of total vote or value of shares. Foreign corporations and life insurance

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[50] Thus, premiums for reinsurance with respect to contracts, reserves for which constitute life insurance reserves for purposes of determining whether a company is a life insurance company, are not nontaxed reinsurance premiums. See section 816(a), (b), (c), (e), (f), and (h).

companies are not excluded, and no attribution of stock ownership through a tax-exempt employee's trust described in section 401(a) is made, for purposes of this determination.

Election to treat specified reinsurance income as effectively connected

The bill provides an election for an affiliated foreign reinsurer that is a specified affiliated corporation to be subject to U.S. tax on premiums and net investment income that is specified reinsurance income. This election is intended to provide another option to ensure that these foreign affiliates are not treated less favorably than U.S. reinsurers. Under the election, the deduction disallowance for reinsurance premiums and additional amounts with respect to such reinsurance does not apply, and the exclusion for return premiums, ceding commissions, reinsurance recovered, or other amounts received with respect to such reinsurance does not apply.

Effects of election

The election provides that an affiliated corporation treats specified reinsurance income (which is intended to include both premium income and net investment income) as effectively connected with the conduct of a trade or business in the United States and, for purposes of any treaty between the United States and any foreign country, as income attributable to a permanent establishment in the United States. The effect of the election is that the deduction otherwise disallowed for nontaxed reinsurance is not disallowed, because the premiums are subject to U.S. income taxation under the election. In addition, the excise tax under section 4371 with respect to reinsurance does not apply to the premiums treated as effectively connected with the conduct of a trade or business in the United States by reason of the election.

Specified reinsurance income is subject to tax under subchapter L of the Code to the same extent and in the same manner as if such income were the income of a domestic insurance company.

Foreign tax credit treatment

For purposes of the foreign tax credit, the provision provides that specified reinsurance income treated as effectively connected under the election is treated as foreign source income and is placed in a separate category for purposes of the section 904 limitation on the foreign tax credit, and sections 902, 907, and 960 are applied separately with respect to each item of such income. Treasury Department guidance may permit aggregation of related items of specified reinsurance income for purposes of the separate category under the section 904 limitation and sections 902, 907, and 960, provided such aggregation is consistent with the purpose of the provision.

Specified reinsurance income

Specified reinsurance income for this purpose means all income of a specified affiliated corporation that is attributable to reinsurance to which the provision would apply but for the election.

It is intended that under the provision, specified reinsurance income include with respect to any taxable year, not only (1) all reinsurance premiums (and additional amounts) for which (but for this election) a deduction would be disallowed under the provision and that are received by an electing specified affiliated corporation during the taxable year directly or indirectly, but also (2) the net investment income (within the meaning of section 842(b)) for the taxable year allocable to reinsurance premiums (and additional amounts) with respect to which an election applies (whether for the current or a prior taxable year). 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. The Treasury Department is directed to strictly ensure that, for purposes of determining net investment income, only those deductible items are allowed that are directly allocable to gross investment income that is allocable to premiums (and other amounts that would otherwise be nondeductible to the paying insurance company) taxed as specified reinsurance income under the election.

Specified affiliated corporation

A specified affiliated corporation means any affiliated corporation (within the meaning of the provision) that is a foreign corporation. The corporation must also meet any other requirements imposed by the Treasury Secretary to ensure that tax on specified reinsurance income is properly determined and paid.

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 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, 2011.