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ITB 09-64: Neal reintroduces foreign reinsurance tax bill

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Alert 09-03

On July 31, 2009 Congressman Richard Neal (D-MA) introduced a foreign reinsurance Bill ("2009 Bill") reflecting his 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. Representative Neal previously introduced H.R. 6969 ("2008 Bill") in the 110th Congress on September 18, 2008, which was substantially similar to the 2009 Bill. Furthermore, the Senate Finance Committee released a draft Bill similar to H.R. 6969 on December 10, 2008. Under the provisions of the 2009 Bill, as in the 2008 Bill, the deduction for a portion of reinsurance premiums paid to foreign affiliates will be disallowed. However, the 2009 Bill has two major changes from the 2008 Bill, which are discussed below.

Generally, the 2009 Bill would disallow (similar to the 2008 Bill) any deduction to covered insurance companies for excess reinsurance premiums with respect to affiliated non-taxed reinsurance premiums. The term 'affiliated non-taxed reinsurance premium' means any reinsurance premium paid directly or indirectly to an affiliated corporation if, with respect to such affiliated corporation, such premium is neither subpart F income (as defined in section 952) nor subject to tax under this subtitle. The amount of premiums which would (but for this clause) be treated as affiliated non-taxed reinsurance premiums with respect to any affiliated corporation for any taxable year shall be reduced (but not below zero) by any reinsurance premiums paid directly or indirectly to the covered insurance company by such affiliated corporation during such taxable year.

Excess reinsurance premiums are those affiliated non-taxed reinsurance premiums paid to affiliates 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.

A covered insurance company for purposes of this Bill is any company subject to tax imposed by section 831 of the Code.

A qualified ceding commission 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 non-taxed reinsurance premiums paid by the covered insurance company during the taxable year. This portion is determined by the ratio of (i) the amount of affiliated non-taxed 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 non-taxed premiums paid by the company that year.

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."

According to the 2009 Bill, which is similar to the 2008 Bill, 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. An 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 would be determined and 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 by line of business.

The amount of the premium limitation for any line of business for the taxable year is the excess of the company's gross premiums written multiplied by industry fraction, less the aggregate reinsurance premiums paid by the company that are not affiliated non-taxed reinsurance premiums. This is the maximum amount that is allowed as a deduction for reinsurance paid to affiliates under the provision. The premium limitation may not be less than zero. The legislation would disallow entirely 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.

Based on the language of both the 2008 and 2009 Bills, it appears that U.S. treaties will not override this Bill.

Example

Assume Company A, a covered insurance company, pays $1,000,000 of reinsurance premiums. Company A pays $900,000 to affiliates and $100,000 to nonaffiliates. Assuming that the industry fraction is 50% ($500,000), Company A’s premium limitation would be $400,000 [i.e., $500,000 - $100,000 = $400,000]. Therefore of the $900,000 premiums paid to affiliates, Company A's excess reinsurance premiums are $500,000 ($900,000 - $400,000), and the deduction for such excess is disallowed.

PwC observations

1. The legislation provides Treasury the authority to carry out or prevent the avoidance of the provisions of this Bill. The legislation would be effective for taxable years beginning after December 31, 2009.

2. The disallowed deduction is lost under this provision. The Technical Explanation to the Bill ("Technical Explanation") has analogized this provision to the interest disallowance under section 163(j). However, interest disallowed under the section 163(j) provision is merely deferred.

3. Although the deduction for reinsurance premiums paid to affiliates may be disallowed, there does not appear to be any relief provided to any excise tax that may be imposed under section 4371.

4. The industry fraction is computed separately for each line of business. Thus, there could be significant variations in the industry fraction.

5. The Neal bill applies to covered companies, which are defined as companies that are taxed under section 831. Therefore, it appears that a life insurance company is not a covered insurance company as it is taxed under section 801 and not section 831.

6. Section 831(d) provides a cross reference to section 842 for taxation of foreign insurance companies. Section 842(a) provides that if a foreign company carrying on an insurance business within the U.S. would qualify under part I or II of subchapter L for the taxable year (without regard to its effectively connected income (ECI)) then that company shall be taxable under such part on its ECI. Accordingly, a nonlife foreign insurance company with a U.S. branch would be subject to section 831 with respect to its ECI and therefore that U.S. branch appears to be subject to the Neal Bill.

7. The Neal bill could apply to certain domestic captive insurance companies. For example, a foreign-parented U.S. group that insures its risks with a domestic captive insurance company, which in turn reinsures its risks to a foreign captive insurer owned by the foreign parent, appears to be subject to the Neal bill.

Key differences between the 2008 and 2009 Bills

A. Exception for CFCs

Under the 2008 Bill, the term 'affiliated non-taxed reinsurance premium' meant any reinsurance premium paid directly or indirectly to an affiliated corporation (other than a controlled foreign corporation (as defined in section 957)) if no tax is imposed by this subtitle with respect to such premium.

Under the 2009 Bill, the term 'affiliated non-taxed reinsurance premium' means any reinsurance premium paid directly or indirectly to an affiliated corporation if, with respect to such affiliated corporation, such premium is neither "subpart F income (as defined in section 952)" nor subject to tax under this subtitle.

PwC observations

Under the 2008 Bill, a controlled foreign corporation was not treated as an affiliated corporation. Thus reinsurance premiums paid to it would not have been treated as affiliated non-taxed reinsurance premiums, regardless of whether it was subpart F income or whether it was subject to U.S. tax. Under the 2009 Bill the reinsurance premiums are treated as affiliated non-taxed premiums unless they are subpart F income or subject to U.S. tax. Therefore, under the 2009 Bill more affiliate reinsurance arrangements are potentially subject to disallowances, because it is possible that such reinsurance premiums may not be subpart income when a CFC has no earnings and profits under section 952(c).

B. Election to be taxed in the U.S. as a branch versus a domestic corporation

Under the 2008 Bill, a foreign corporation could have elected under section 953(d) to be treated as a domestic corporation for U.S. income tax purposes.

The 2009 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 transactions.

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. The term 'specified affiliated corporation' means any affiliated corporation which would be taxed as an insurance company if it were a domestic corporation, that elects to waive its treaty benefits with respect to the specified reinsurance income, and meets such requirements as the Secretary shall prescribe. The term 'specified reinsurance income' generally means the affiliated non-taxed reinsurance premiums which are received by such corporation during such taxable year directly or indirectly from covered insurance companies with respect to which such corporation is affiliated, and the net investment income (within the meaning of section 842(b)) for such taxable year as is allocable to reinsurance premiums with respect to which an election under clause (i) applies for such taxable year or any prior taxable year.

PwC observations

1. The 2009 Bill states that the election treats the specified reinsurance income as income effectively connected with the conduct of a trade or business in the United States. A literal reading of this provision would seem to provide that the specified reinsurance income becomes subject to the branch profits tax and branch interest tax under section 884. Moreover, as the electing specified affiliated corporation has to waive all benefits granted by the United States under any treaty between the United States and any foreign country at least as to the specified reinsurance income, the branch profits tax and branch interest tax may not be reduced by any treaty. 1. The 2009 Bill states that the election treats the specified reinsurance income as income effectively connected with the conduct of a trade or business in the United States. A literal reading of this provision would seem to provide that the specified reinsurance income becomes subject to the branch profits tax and branch interest tax under section 884. Moreover, as the electing specified affiliated corporation has to waive all benefits granted by the United States under any treaty between the United States and any foreign country at least as to the specified reinsurance income, the branch profits tax and branch interest tax may not be reduced by any treaty.

2. It appears that, if the election is made, the entire affiliated non-taxed premium, not just the non-deductible portion, paid to the specified affiliated corporation is treated as ECI. 2. It appears that, if the election is made, the entire affiliated non-taxed premium, not just the non-deductible portion, paid to the specified affiliated corporation is treated as ECI.

3. The electing specified affiliated corporation is treated as carrying on an insurance business within the United States. This would indicate that the corporation is subject to section 842. Therefore the minimum effectively connected net investment income of that corporation (as defined by section 842(b)), would be subject to U.S. tax. Certain U.S. treaties such as the U.S./Canada Treaty may allow the U.S. permanent establishment to attribute income to the permanent establishment based on its facts and not under the deemed minimum investment income calculation of section 842(b). However, as specified reinsurance income by definition includes this minimum effectively connected income, and the corporation is precluded from claiming treaty benefits with respect to specified reinsurance income, section 842(b) would appear to apply without any treaty relief. 3. The electing specified affiliated corporation is treated as carrying on an insurance business within the United States. This would indicate that the corporation is subject to section 842. Therefore the minimum effectively connected net investment

income of that corporation (as defined by section 842(b)), would be subject to U.S. tax. Certain U.S. treaties such as the U.S./Canada Treaty may allow the U.S. permanent establishment to attribute income to the permanent establishment based on its facts and not under the deemed minimum investment income calculation of section 842(b). However, as specified reinsurance income by definition includes this minimum effectively connected income, and the corporation is precluded from claiming treaty benefits with respect to specified reinsurance income, section 842(b) would appear to apply without any treaty relief.

4. Section 4373(1) provides that any amount that is effectively connected to the conduct of a U.S. trade or business is not subject to the excise tax. As the specified reinsurance income is treated as effectively connected income, it should not be subject to the insurance excise tax by operation of this exception. 4. Section 4373(1) provides that any amount that is effectively connected to the conduct of a U.S. trade or business is not subject to the excise tax. As the specified reinsurance income is treated as effectively connected income, it should not be subject to the insurance excise tax by operation of this exception.

5. The Technical Explanation notes that the election applies to all reinsurance premiums paid to the affiliated corporation from all covered insurance companies with respect to which such corporation is affiliated. 5. The Technical Explanation notes that the election applies to all reinsurance premiums paid to the affiliated corporation from all covered insurance companies with respect to which such corporation is affiliated.

6. The Technical Explanation provides that "any reinsurance premiums that are disallowed under the provision do not, by definition, satisfy the arm’s-length standard and may properly be disallowed under U.S. tax treaties" and therefore the Technical Explanation asserts that the Neal Bill does not violate the nondiscrimination article of U.S. tax treaties. 6. The Technical Explanation provides that "any reinsurance premiums that are disallowed under the provision do not, by definition, satisfy the arm’s-length standard and may properly be disallowed under U.S. tax treaties" and therefore the Technical Explanation asserts that the Neal Bill does not violate the nondiscrimination article of U.S. tax treaties.

7. The Technical Explanation provides that the electing corporation 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 to strictly 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. 7. The Technical Explanation provides that the electing corporation 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 to strictly 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 additional information please call Richard E. Irvine at (441) 299-7136 or contact your local insurance tax professional.