MEMORANDUM

To: Reporters and Editors

From: Dan Virkstis for Senate Finance Committee Chairman Max Baucus (D-Mont)

Re: Senate Finance Committee Staff Discussion Draft of proposal to modify tax treatment of insurance companies that deduct premiums in excess of the industry average.

Senate Finance Committee staff today released a discussion draft of a proposal to adjust the tax code to ensure that offshore reinsurance entities are taxed appropriately so as to limit any competitive advantage they may currently hold over American companies. The proposal addresses only "related party" reinsurance, e.g. a parent company headquartered offshore reinsuring a policy written by its U.S. subsidiary. The proposal does not affect reinsurance between entities that are unrelated. The proposal would deny a deduction for any premiums reinsured in excess of the industry average of reinsured policies. The Finance Committee intends to use public comment to understand more about the potential implications of any such tax code changes for insurance companies and consumers alike.

In general, domestic U.S. insurance companies pay U.S. tax on insurance premiums and any income earned from investing those premiums. The companies deduct payments of claims as the losses are accrued and they invest the premiums received. Their profit is based on the difference between the premiums received plus the return on investment and the payouts on claims.

Reinsurance, or insurance for an insurance company, is commonplace in the industry. The primary insurer (the company that wrote the policy) transfers a portion of the risk of the underlying policy to the reinsurer (another insurance company). The reinsurer then becomes legally obligated to pay claims for the assumed portion of the policy. The primary insurer pays the reinsurer a premium for assuming that risk. The reinsurer may then earn investment income on the premium, until the claim is paid.

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Under current law, companies pay a one percent excise tax on premiums paid on reinsurance policies issued by foreign insurers (related or unrelated). This was enacted in 1942 to "eliminate an unwarranted competitive advantage now favoring foreign insurers." Most of our tax treaties reduce or waive the excise tax. However, it is not waived for Bermuda. In addition, transfer pricing rules are intended to police the price paid between related parties for the reinsurance.

Despite these rules, foreign insurance companies may have a competitive advantage over U.S. firms because they can use related party reinsurance to reduce their tax liabilities on investment income. This is accomplished when a U.S. subsidiary writes the initial insurance policy and then reinsures the policy to its foreign parent corporation, or "related party," that is located in a low or no-tax jurisdiction such as Bermuda or Switzerland. The U.S. subsidiary deducts the premium and the foreign parent company does not pay U.S. or local tax on the premium while earning investment income subject to low or no tax. In this instance, related party reinsurance does not result in a transfer of risk outside the global group. Thus, it is an efficient way of significantly reducing U.S. tax without transferring risk.

It is the intent of this proposal to address the concerns that current law does not adequately level the playing field between domestic and foreign related party reinsurance. Congress is unable to raise the current law excise tax because it would violate international trade agreements and transfer pricing rules do not distinguish between related and unrelated parties.

The staff draft contains similarities to legislation introduced in the House of Representatives on September 18, 2008 by Representative Richard Neal (D-Mass.), who is Chairman of the Subcommittee on Select Revenue Measures.

Staff encourages public comments including, but not limited to, remarks addressing a) the possible effect on insurance pricing and capacity; b) issues relating to existing treaties and sovereignty rights of other jurisdictions; c) the potential impact of the proposal on the reinsurance market; d) American competitiveness; e) possible impact on the crop insurance market; and e) the effective date of the proposal.

In addition to the draft proposal, staff also released a technical explanation that should be used as a reference for insurance and reinsurance firms seeking to understand the proposal fully for business purposes.

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Copies of the staff discussion draft and the technical explanation of the Chairman's proposal will be available in 219 Dirksen Senate Office Building and on the Public Comment page of the Finance Committee website (finance.senate.gov). Comments should be submitted no later than February 28, 2009. Public comment can be submitted by email to reinsurance@finance-dem.senate.gov or in writing to Russ Sullivan, Democratic Staff Director, at the Senate Finance Committee, 219 Dirksen Senate Office Building, Washington, DC 20510.

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