



NUMBER PB12-3

JANUARY 2012

Another Shot at Protection by Stealth: Using the Tax Law to Penalize Foreign Insurance Companies

Gary Clyde Hufbauer

Gary Clyde Hufbauer, *Reginald Jones Senior Fellow since 1992, was the Maurice Greenberg Chair and Director of Studies at the Council on Foreign Relations (1996–98), the Marcus Wallenberg Professor of International Finance Diplomacy at Georgetown University (1985–92), senior fellow at the Institute (1981–85), deputy director of the International Law Institute at Georgetown University (1979–81), deputy assistant secretary for international trade and investment policy of the US Treasury (1977–79), and director of the international tax staff at the Treasury (1974–76). He has written extensively on international trade, investment, and tax issues. Among his numerous books are Figuring Out the Doha Round (2010), Global Warming and the World Trading System (2009), Economic Sanctions Reconsidered, 3d ed. (2007), and US-China Trade Disputes: Rising Tide, Rising Stakes (2006).*

© Peter G. Peterson Institute for International Economics. All rights reserved.

The United States suffers from a severe self-inflicted wound. Together, federal and state governments impose almost the highest corporate tax rate found among advanced countries, 39 percent. Only Japan is fractionally higher. The high US rate has adverse consequences—lost investment, lost jobs, and less innovation—and goes a long way to explain slipping US competitiveness in the world economy.¹

1. The adverse consequences are spelled out in two policy briefs: Hufbauer, Gary Clyde, and Woan Foong Wong. 2011. *Corporate Tax Reform for the New Century*. PIIE Policy Brief 11-2. Washington: Peterson Institute for International Economics. Available at <http://www.iie.com/publications/pb/pb11-02.pdf>. And by Hufbauer, Gary Clyde, and Martin Vieiro. 2011. *US Tax Discrimination Against Large Corporations Should be Discarded*.

Some US-based companies that face competition from foreign-based companies think they have found the answer: by one means or another, persuade Congress to impose US taxation on the foreign companies. Instead of attacking the root problem—exceptionally high US corporate taxes—this “solution” seeks to handicap foreign competitors with the same burdensome tax system that handicaps US-based firms when they do business at home and abroad.

This “solution” has a fundamental flaw: It violates the sovereign right of each country to determine its own corporate tax system, a right enshrined in double tax treaties and the World Trade Organization (WTO). A technical appendix to this policy brief explains US obligations in detail. However, the logic of treaty rights can be easily explained. Suppose that Mitsubishi, a Japanese manufacturer of heavy equipment, paid an even higher corporate tax rate than General Electric. Could Japan “even the score” by taxing GE’s profits on its manufacture of power turbines in the United States? Certainly not. The mere suggestion would provoke a righteous howl from the US government.

Yet that is exactly the “solution” that Representative Richard Neal (D-MA) and Senator Robert Menendez (D-NJ) seek to impose on foreign-based insurance companies through parallel bills introduced in October 2011, respectively H.R. 3157 and S. 1693. Regrettably, the Obama Administration included similar provisions in its fiscal year 2012 budget proposals.²

Earlier versions of the same bill were introduced by Representative Neal beginning in 1998. My Peterson Institute policy brief criticized the 2009 version of the Neal bill (H.R. 3424).³ What’s new this time around? Tax discrimination takes a different form. Specifically, a deduction would be denied

PIIE Policy Brief 11-16. Washington: Peterson Institute for International Economics. Available at <http://www.iie.com/publications/pb/pb11-16.pdf>.

2. US Department of the Treasury. General Explanation of the Administration’s Fiscal Year 2012 Revenue Proposals, page 46. February 2011.

3. See Hufbauer, Gary Clyde. 2010. *Protection by Stealth: Using the Tax Law to Discriminate Against Foreign Insurance Companies*. PIIE Policy Brief 10-9. Washington: Peterson Institute for International Economics. Available at <http://www.piie.com/publications/pb/pb10-09.pdf>.

for reinsurance premiums and any additional amounts paid to a foreign affiliate by a foreign-owned insurance company doing business in the United States. Reinsurance claims, return premiums, ceding commissions, and other amounts paid currently or years later by the foreign affiliate to the US firm would not be taxed by the United States to the extent of deductions denied.

Perhaps at first glance this scheme seems fair. It is anything but. The same denial of deductions does not apply to US-owned insurance companies. Even if reinsurance claims, return premiums, ceding commissions, and other amounts paid exactly match deductions denied, the foreign-owned company loses the time value of money. Typically, commercial

**The self-inflicted damage to the
United States will come much sooner
if Congress embraces this
piece of tax discrimination.**

reinsurance claims relate to complex business risks that are paid many years later and would represent the overwhelming majority of disallowed deductions. Finally, since the foreign reinsurance affiliate is in business to make a profit, its receipts (the deductions denied) will normally be greater than its payments (claims). Thus, in an indirect fashion, the foreign-owned company doing business in the United States will end up paying the US corporate tax rate on the foreign affiliate's profit.

While different in structure than earlier versions of the Neal bill, this scheme is just as offensive to double tax treaties signed by the United States, and to the General Agreement on Trade in Services (GATS), a vital component of the WTO championed by the United States. Not surprisingly, the European Commission has registered its objection. In a statement issued October 12, 2011, Representative Neal stated "The proposed legislation is consistent with US tax treaty and trade agreement obligations." Foreign partners disagree, and so will the WTO arbitration panel if the legislation is enacted.

But the self-inflicted damage to the United States will come much sooner if Congress embraces this piece of tax discrimination. State legislators in Florida, Texas, and Louisiana have passed memorial resolutions objecting to the bill. Nine Florida Congressmen wrote a letter on November 17, 2011, to the Chairman and Ranking Member of the House Ways and Means Committee, objecting to the bill. Hurricanes inflict serious damage on Florida and other southern states, and reinsurance written by foreign affiliates pays a major portion

of claims.⁴ This portion of the insurance market will either shut down or premiums will rise to cover the new tax burden. Either way, household and business consumers will suffer. The Joint Tax Committee scores the latest Neal bill as raising \$12 billion over 10 years. By contrast, the Brattle Group published a report estimating that the 2009 version of the Neal bill would cost consumers \$11 billion each year.⁵ The bill is clearly not the tax equivalent of a free lunch. But the estimates do not necessarily conflict with one another. It is possible for the new tax to raise revenue from those foreign reinsurance firms that remain in the US market, but the departure of other foreign reinsurance firms could lead to higher premium rates charged by the remaining foreign and domestic reinsurance firms.

The US-owned insurance companies that are championing the Neal and Menendez bills should consider the possibility that "look alike" legislation abroad could harm their own operations. This is not an idle fear. In 2008, after 70 years of a state-owned monopoly, Brazil opened its reinsurance market to private firms, including foreign firms. However, in December 2010 and March 2011, to protect its domestic insurance industry, Brazil issued Resolutions 225 and 232 that required 40 percent of reinsurance to be placed with Brazilian-owned companies and capped reinsurance payments to foreign affiliates at 20 percent of the initial premium.⁶ US-owned insurance companies operating in Brazil rightly objected to this protectionist outbreak. But US protests over such measures, and US efforts to open foreign reinsurance markets, will be seriously undermined if the United States enacts its own version of stealth protection. Since US insurance firms are among the most competitive in the world, it seems likely that the United States would lose from emulation abroad—particularly since protectionist copycats are likely to include the big emerging markets with a high potential for insurance growth. These countries include Brazil, Russia, India, China, and South Africa—the classic BRICS.

There is no reason for the US Congress to go down the path of tax discrimination, harming relations with foreign partners and imposing high costs on American consumers

4. In the wake of the events of September 11, 2001, international insurance and reinsurance firms paid 64 percent of all US claims. In the wake of hurricanes Katrina, Wilma, and Rita, they paid 47 percent of all claims. International insurance companies are also major providers of earthquake insurance in California and windstorm insurance in Texas.

5. The Brattle Group. 2009. *The Impact on the U.S. Insurance Market of a Tax on Offshore Affiliate Reinsurance: An Economic Analysis*. Available at <http://www.rims.org/aboutRIMS/Newsroom/PressReleases/Documents/TheImpactontheUSInsuranceMarketofaTax.pdf>.

6. See <http://brazilianchamber.org.uk/committees/legal-committee/newsletter/changes-new-reinsurance-regulations> and <http://www.kennedys-law.com/article/reinsurancebrazil/>.

who live in disaster-prone regions. Instead, the US Congress should focus on corporate tax reform that puts US companies on the same competitive playing field as their foreign rivals.

TECHNICAL APPENDIX: INTERNATIONAL AGREEMENTS IN A NUTSHELL

WTO and GATS

In 1995, at the conclusion of the Uruguay Round of Multilateral Trade Agreements which created the World Trade Organization (WTO) and the General Agreement on Trade in Services (GATS), the United States inscribed insurance under its Schedule of GATS commitments. This locks in the obligations of the first paragraph of Article XVII *National Treatment*, which reads:

1. In the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than it accords its own like services and service suppliers.⁷

In the WTO Financial Services Agreement (FSA), an annex to the GATS concluded in 1998, the United States scheduled a market access commitment for the cross-border supply of reinsurance, including national treatment for reinsurance services and service suppliers.⁸ Only two exceptions to national treatment for reinsurance pertain under the FSA and GATS, one specific and one general. The specific exception under the FSA relates to a 1 percent federal excise tax (FET) on reinsurance premiums paid to foreign companies when they cover US risks; however, the FET is not imposed when the premium is paid by a US office or agency of the foreign company.⁹

7. See GATS Article XVII(1), WTO. Available at http://www.wto.org/english/docs_e/legal_e/26-gats_01_e.htm#articleXVII.

8. US Schedule of Specific Commitments, Supplement 3, WTO Document GATS/SC/90/Suppl.3. February 26, 1998. Available at http://www.wto.org/english/tratop_e/serv_e/serv_commitments_e.htm.

9. The specific language for the exception for retrocession and reinsurance premiums paid under GATS mode 1 reads: "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 United States. In Texas, total direct reinsurance of mutual life insurance companies may not be entered into with non-US companies." See US Schedule of Specific Commitments, Supplement 3, WTO Document GATS/SC/90/Suppl.3. February 26, 1998. Available at http://www.wto.org/english/tratop_e/serv_e/serv_commitments_e.htm.

The general exception relates to GATS Article XIV(d), which permits a difference in the manner of imposing "direct taxes in respect of services or service suppliers of other Members," provided that the difference does not "constitute a means of arbitrary or unjustifiable discrimination... or a disguised restriction on trade in services." This exception does not come into play for two reasons: The Neal bill imposes an indirect tax not a direct tax; and whatever the label, the difference in taxation between US and foreign insurance companies amounts to "arbitrary or unjustifiable discrimination."

Like its predecessors, the vintage 2011 Neal bill contains an election that the affiliated foreign-based reinsurance firm can execute, and choose to be taxed as a US firm, thereby relieving the US-based (but foreign-owned) insurance firm from the tax penalty. But the election is meaningless, since it only offers the foreign-owned group a choice to jump from the frying pan into the fire: If it made the election, the foreign-owned group would face an overall tax burden that discriminates to an even greater extent.¹⁰

Today, the United States has more than 50 double tax treaties in force.

If it comes to WTO arbitration, the Neal bill cannot be saved by calling the denial of reinsurance premium deductions a "direct tax." This linguistic escape hatch would attempt to take advantage of the exclusion of direct taxes from the national treatment requirement of GATS Article XVII, by way of GATS Article XIV(d). But the attempt fails.

Article XIV(d) requires that any difference in direct taxes between US-owned firms and foreign-owned firms should not "constitute a means of arbitrary or unjustifiable discrimination... or a disguised restriction on trade in services." The fact that the Neal bill has been championed by US-owned insurance firms speaks to the possibility that it constitutes a "disguised restriction on trade." This possibility is reinforced by the repeated references to the competitive disadvantage

10. Many US-owned insurance companies control reinsurance affiliates based abroad which are subject to total tax burdens at less than the US statutory rate. However, the election in the Neal bill would only subject foreign-owned insurance companies with reinsurance affiliates based abroad to the US statutory rate. Unlike the rules for US-owned insurance companies that are taxed on their actual underwriting and investment income, electing foreign insurers also may be subject to IRC Section 842(b), which would require taxation of deemed amounts of US effectively connected income. But see the decision in *The North West Assurance Co. of Canada*, 107 T.C. 363 (1966), where the US Tax Court rejected the application of Section 842(b) based on contrary language in the Canada-US tax treaty.

faced by US insurers and reinsurers. Moreover, the Neal bill surely imposes “arbitrary or unjustifiable discrimination” since, by a simple drafting change, the same deduction disallowance could be applied to all US insurance companies, whether US-owned or foreign-owned.

Returning to common sense, supported by internationally agreed definitions of indirect taxes in the WTO Agreement on Subsidies and Countervailing Measures (ASCM), it requires a linguistic contortion to characterize the Neal bill as a direct tax rather than an indirect tax. An expense deduction normally claimed by insurance companies—namely payment of reinsurance premiums to another firm—would be denied for purposes of computing net income. The resulting tax is a tax on revenue, not a tax on net income as commonly understood.

Double Tax Treaties

Following ratification in 1913 of the 16th Amendment to the US Constitution, which permitted the imposition of income taxes, the United States began to negotiate bilateral tax treaties with other countries to avoid the double taxation of income. Today, the United States has more than 50 double tax treaties in force. Non-discrimination is a fundamental clause of these treaties. For example, in the 1985 treaty with Canada, the fifth paragraph of Article XXV, titled *Non-Discrimination*, reads:

5. Any company which is a resident of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which

other similar companies of the first-mentioned State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of a third State, are or may be subjected.

Current US tax law allows US insurance companies (whether US-owned or foreign-owned) to deduct reinsurance premiums paid to affiliated or unaffiliated insurance companies based abroad as well as those based in the United States. Since federal income taxes are covered by the Canada-US double-tax treaty, it would be inconsistent for the United States to deny Canadian-owned insurance companies based in the United States the deduction for reinsurance premiums paid to their foreign affiliates.¹¹ By the same token, it would be inconsistent with the *Non-Discrimination* provisions in other double tax treaties to deny companies based in those countries the deduction for reinsurance premiums.

11. US law imposes a FET at a rate of 1 percent on reinsurance premiums paid to a foreign insurance company. However, the FET is waived in whole or part by US tax treaties with 29 countries, including treaties with France, Germany, Ireland, Switzerland, and the United Kingdom. Because the United States does not have a double tax treaty with Bermuda, reinsurance premiums paid to affiliates based in that country pay the 1 percent FET.

The views expressed in this publication are those of the author. This publication is part of the overall programs of the Institute, as endorsed by its Board of Directors, but does not necessarily reflect the views of individual members of the Board or the Advisory Committee.