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## Protection by Stealth: Using the Tax Law to Discriminate against Foreign Insurance Companies

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These are difficult times. Not only are 10 percent of Americans unemployed but the federal budget is out of whack thanks to the specter of rising entitlement outlays. A natural impulse in difficult times is to protect domestic products and domestic producers. The tone of political economy during the global recession of 2007–09 is no different from that in past recessions—but louder because the economic damage is more severe. Emblematic of this spirit is a proposal to discriminate against foreign-owned insurance companies, using the tax code.

Under the broad canopy of trade and investment protection, opportunistic flowers are sometimes linked to worthy public policy objectives. So it is with the Neal bill (HR 3424), named after Congressman Richard Neal (D-MA).<sup>1</sup> This bill (first

introduced in 1998) would tax foreign-owned insurance companies doing business in the United States more heavily than US-owned insurance companies doing exactly the same business in the United States. The worthy goal in this instance is to prevent tax abuse. However, the structure of the bill has provoked well-founded protests from Europe. If enacted the bill would likely be challenged in the World Trade Organization (WTO).

Besides breaking international obligations, what's the harm of tax discrimination against foreign-owned insurance companies? In the wake of 9/11, 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.<sup>2</sup> International insurance companies are major providers of earthquake insurance in California and windstorm insurance in Texas. Some 13 of the 19 reinsurance companies that report data to the Reinsurance Association of America are foreign owned. In addition to reinsurance, foreign-owned insurance companies operating in the United States are big players in the “surplus lines” category of insurance—mainly large industrial or commercial risk policies. Catastrophic losses covered by reinsurance or surplus lines call on the deep pockets of the global insurance industry. When the next disaster strikes, the US economy would hardly benefit from the departure of foreign-owned insurance companies and their foreign affiliates. Yet the Neal bill will go some distance toward driving these companies away.

Equally important, it is a bad idea to deny US nonfinancial companies the benefit of competition between US-owned and foreign-owned firms in an industry that collects hundreds of billions of dollars of premiums annually.

### INTERNATIONAL AGREEMENTS IN A NUTSHELL

In a moment I will delve into the details of the heavier tax burden and its potential impact on the US insurance market. But even without these details, tax discrimination is bad policy per se: It violates the national treatment provision of the WTO's General Agreement on Trade in Services (GATS)—an agreement vigor-

1. The bill titled “To amend the Internal Revenue Code of 1986 to disallow the deduction for excess non-taxed reinsurance premiums with respect to United States risks paid to affiliates” was referred to the House Committee on Ways and Means on July 30, 2009. The text of the bill is available at <http://frwebgate.access.gpo.gov>.

2. See the European insurance and reinsurance federation (CEA), “CEA Response to US Senate Finance Discussion Draft to disallow the deduction of reinsurance premiums with respect to United States risks paid to affiliates,” CEA letter dated February 27, 2009, available at [www.cea.eu](http://www.cea.eu). Also see “CEA Comment on US proposal disallowing tax deduction of certain affiliated reinsurance premiums,” April 9, 2010, available at [www.cea.eu](http://www.cea.eu).

ously championed by the United States—and the nondiscrimination provisions of US income tax treaties designed to prevent double taxation. If the Neal bill or something like it is enacted, European countries are almost certain to bring a case against the United States in the WTO and seek whatever redress they can under US income tax treaties. Some European countries might consider tit-for-tat retaliatory legislation that would hurt US-owned insurance companies. While legal and retaliatory battles

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are waged, some foreign-owned insurance companies might reconsider their presence in the US insurance market—a role that has greatly benefited the US households and firms that suffered catastrophic losses in the wake of 9/11 and Hurricane Katrina.

The scenario just painted is quite unnecessary. Tax abuse in the insurance market, if it exists, can be addressed without discriminating against foreign-owned companies.

In 1995, the United States inscribed insurance under its schedule of GATS commitments. This locks in the obligations 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.

The only pertinent exception to the national treatment obligation is the provision, not in the US schedule but rather in GATS Article XIV(d): General Exceptions, 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.”

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 double taxation of income. Today, the United States has more than 50 double-tax treaties in force. Nondiscrimination is a fundamental clause in these treaties. For example, Article 24: Non-Discrimination of the 1998 treaty with Switzerland provides:

1. Nationals [including legal persons] of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected.

US taxes covered by the Swiss double-tax treaty include federal income taxes and excise taxes imposed on insurance premiums. The same coverage applies to a number of other countries that are US treaty partners. However, premiums paid to a foreign reinsurance company that resides in a country that is not a party to a standard double-tax treaty with the United States are not covered.

#### THE NEAL BILL IN BRIEF

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 in the United States. However, premiums paid to a foreign-based insurance company are subject to a federal excise tax (FET) at the rate of 1 percent of the gross premium—unless the company is based in a country covered by a double-tax treaty with a waiver provision similar to the Swiss treaty quoted above or the premiums are “effectively connected” to the conduct of a US trade or business. Because the narrow-gauge US tax treaty with Bermuda does not waive the FET, reinsurance premiums paid to affiliates based in that country generally pay the 1 percent FET.<sup>3</sup>

The Neal bill would limit the tax deductibility of reinsurance premiums paid by a foreign-owned insurance company based in the United States to its foreign affiliates, but the same limit would not apply to a US-owned insurance company. Specifically, the bill creates a benchmark, called the “industry fraction,” which represents the US industry average level of nonaffiliated reinsurance by line of business. When a foreign-owned company pays

3. Many reinsurance firms have affiliates based in Bermuda, both because the legal regime is stable and because taxes are low. If the Bermuda reinsurance premium income is “effectively connected” to a US trade or business, and therefore subject to US tax, the FET does not apply. Note that Bermuda is not a member of the WTO.

premiums both to its nonaffiliated and affiliated reinsurers that exceed the “industry fraction,” the excess is disallowed as a deduction, to the extent of premiums paid to affiliated reinsurers.<sup>4</sup>

The Neal bill does contain an election that the affiliated foreign-based reinsurance firm can execute, and elect 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. Many US-owned insurance companies control reinsurance affiliates based abroad, which are subject to total tax burdens at less than the

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US statutory rate. However, the election in the Neal bill would subject foreign-owned insurance companies with reinsurance affiliates based abroad not only to the US statutory rate but also to the branch profits tax of 30 percent on top of that.

The Joint Committee on Taxation (JCT) has scored the Obama administration proposal, which is similar to the Neal bill, as raising \$2.3 billion over ten years. That makes it an attractive “pay for” in the context of specific legislative proposals that are working their way through Congress. The Obama administration’s own score for its proposal has it raising \$520 million over ten years—a far more realistic estimate. However, it is the JCT score that counts for “pay for” purposes.

One might ask why the Neal bill (and the related administration proposal) does not raise still more money by applying its limits on deductibility to all US insurance companies, whether US-owned or foreign-owned. The snappy answer is straightforward: Several US-owned insurance companies support the Neal bill as written, but the coalition is not enthusiastic about increas-

ing its own tax burden. The deeper answer is that the United States will severely undermine its competitiveness in the global economy by embarking on a course of higher corporate tax rates.

### **CAN THE NEAL BILL BE SAVED BY CALLING THE MEASURE A DIRECT TAX?**

The short answer is “no.” If by some torture of language, the Neal bill is said to impose a direct tax, and thus escapes the national treatment requirement of GATS Article XVII—by way of GATS Article XIV(d)—the quick reply should be “not so fast.”

Article XIV(d) requires that any difference in direct taxes between US-owned 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 technical explanation of the bill, which argues that current law operates as a “competitive disadvantage for U.S. 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, it requires a linguistic contortionist 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. Yet losses paid by the reinsurance affiliate would be included in the gross income of the foreign-owned US-based insurance company. Put these facts together and you have a tax on revenue, not a tax on net income.

If the Neal tax is magically characterized as an income tax, what about the nondiscrimination obligations of the US-Swiss double-tax treaty and multiple other double-tax treaties? Do those obligations get tossed out the window?

As for breaking international obligations, two can play that game. If the United States ignores its commitments, and imposes discriminatory taxes on foreign-owned companies, it is only a matter of time before European nations impose payback taxes on US-owned companies. In the meantime, a legal case in the WTO seems all but certain.

Is this the right way for the world’s most powerful country to write its tax laws?

4. This brief discussion omits mention of “ceding commissions”—i.e., commissions paid by the reinsurance firm back to the originating insurance firm—but such commissions play little or no role in the discrimination between foreign-owned and US-owned firms.