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Legislation Introduced Targeting Related Party Reinsurance

On July 30, 2009, Representative Richard E. Neal (D-Mass) introduced a bill ("H.R. 3424"), which would disallow deductions for certain non-life reinsurance premiums paid to affiliated foreign reinsurers. Representative Neal previously introduced a substantially similar bill last September ("H.R. 6969").

H.R. 3424 is the latest action in a long running controversy over claims by some domestic insurance companies that federal tax laws give offshore reinsurers a competitive advantage with respect to the insurance of U.S. property and casualty risks.

Background

Non-life insurance risks located in the U.S. are typically covered by direct insurance issued by domestic insurers. For a variety of reasons, including financial support, additional capacity, and protection against catastrophes, a portion of that risk is frequently reinsured with a reinsurer. In some situations, the domestic insurer reinsures U.S. risks with an affiliated reinsurer located in a foreign jurisdiction with favorable tax laws ("related party reinsurance"). In other cases, the domestic insurer reinsures U.S. risks with an unrelated reinsurer.

Some domestic insurers have argued that the availability of offshore related party reinsurance gives some domestic insurers a U.S. tax advantage, based on the claim that through excessive amounts of related party reinsurance these domestic insurers can reduce the U.S. tax on their U.S. insurance operations. On the other hand, others have argued that the U.S. tax laws are already adequate to curb abuses and that reinsurance with foreign reinsurers is currently subject to an excise tax. Thus, it is argued that there is no need for new laws to address related party reinsurance, and any such laws would be anti-competitive, raise treaty issues, and ultimately result in higher insurance premiums for U.S. consumers.

Different legislative proposals have been proposed from time to time to address this perceived problem. As noted above, for example, last fall Representative Neal introduced H.R. 6969. In addition, in December of last year, the Senate Finance Committee staff released a draft of a bill very similar to H.R. 6969 and H.R. 3424.

Proposals to address related party reinsurance also are part of a broader legislative context involving transactions with offshore companies. The Obama Administration is proposing significant reforms to the U.S. tax rules applicable to foreign transactions, and bills have been introduced in Congress to address international tax abuse concerns. For example, earlier this year both the House and the Senate introduced versions of the "Stop Tax Haven Abuse Act" ("S. 506" and "H.R. 1265"), which would, among other things, create adverse tax and other legal presumptions regarding transactions with foreign parties located in "offshore secrecy jurisdictions" (e.g., Bermuda, Switzerland, Luxembourg). One particularly onerous presumption in the Stop Tax Haven Abuse Act, which could broadly apply to reinsurance, is that any amounts transferred to an offshore secrecy jurisdiction constitute unreported income that is subject to U.S. income tax. (In addition to the Stop Tax Haven Abuse Act, a draft of a competing, more narrowly defined bill, has been circulated by Senator Baucus.) This level of legislative activity may suggest that Congress ultimately will take some form of action to address offshore transactions.

Overview of H.R. 3424

H.R. 3424 provides for the disallowance of a tax deduction for "excessive," "nontaxed" reinsurance premiums paid by a domestic, non-life insurer to a foreign reinsurer, where the foreign reinsurer is an affiliate of the domestic insurer. For this purpose, a reinsurance premium is considered "nontaxed," in very general terms, if it is not fully subject to U.S. income taxes in the hands of the foreign reinsurer.

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Legislation Introduced Targeting Related Party Reinsurance (cont'd.)

Nontaxed reinsurance premiums are considered “excessive” if they exceed a specially computed “premium limitation” (increased for any “qualified” ceding commissions paid to the domestic insurer by the foreign reinsurer). The premium limitation is determined separately for each line of business. The premium limitation for a particular insurer is calculated in several steps. First, the Treasury Department would be required to calculate and publish an “industry fraction” for each line of business. The numerator of the industry fraction would be the total amount of reinsurance premiums paid by all domestic reinsurers to non-affiliated reinsurers during a given year. The denominator would be the total amount of gross premiums written by those insurers. Second, a domestic reinsurer would multiply its total gross premiums written in a line of business by the applicable industry fraction. Third and finally, this product would be reduced (but not below zero) by any reinsurance premiums actually paid by the domestic reinsurer that are not affiliated non-taxed reinsurance premiums. The amount calculated under these three steps is the premium limitation for a particular domestic insurer for a given line of business. If the domestic insurer pays non-taxed reinsurance premiums to an affiliated reinsurer that are in excess of this premium limitation, then no deduction is allowed for this excess amount.

H.R. 3424 would allow a foreign reinsurer to elect to be taxable as a domestic insurer on its reinsurance business with affiliated domestic insurers, subject to certain conditions. If this election were made, then the deduction for reinsurance premiums paid would not be subject to disallowance. H.R. 3424 would be effective for taxable years beginning after December 31, 2009.

Conclusion

Congress appears likely to actively pursue legislative reform proposals relating to international taxation, which may include H.R. 3424 or similar proposals to address related party reinsurance.

In concert with Locke Lord Strategies®, our legislative affairs group, we are monitoring legislative developments in the international tax arena,

including H.R. 3424. For any questions about H.R. 3424 or tax legislative developments generally, please contact either of the authors.

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About the Authors

William J. Kelty, III is the managing partner of LLB&L's Washington, D.C. office. He has extensive experience in a wide range of insurance regulatory and transactional issues, with particular concentration in insurance company sales, mergers and acquisitions (including contested acquisitions), financings, investments, reinsurance transactions (including bulk reinsurance, indemnity, co-insurance, and modified co-insurance and assumption transactions), insurance holding company act transactions, risk securitization, corporate governance and other general corporate matters and related regulatory and judicial proceedings.

Kirk Van Brunt is a partner at LLB&L. He focuses his practice on the taxation of financial institutions and products, with a particular focus on insurance companies and insurance products. Within the insurance arena, Mr. Van Brunt has substantial experience with bank/corporate owned life insurance (BOLI/COLI) and is very active within the structured settlement industry. Mr. Van Brunt also has substantial experience in the tax treatment of asset-backed securities (especially tax issues relating to REMICs) and derivative financial instruments.