Reinsurance Transactions Under a Destination-Based Cash Flow Tax

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It's unclear how a destination-based cash flow tax, if enacted, would apply to reinsurance transactions and whether in the insurance context it would achieve its intended results: improving the competitiveness of U.S. insurance companies and returning offshore reinsurance operations back to the United States.

The proponents of the border adjustability tax in the House GOP tax reform blueprint seek to level the playing field for U.S. businesses competing with offshore companies and reduce incentives for U.S. companies to relocate their operations to no-tax or low-tax jurisdictions. Under the proposal, products, services, and intangibles exported outside the U.S. will not be subject to U.S. tax regardless of where they are produced, while imports into the U.S. will be taxed.

Prospects for the House GOP plan were in doubt following expressions of skepticism from some fellow congressional party members, but President Trump reinvigorated hopes for its passage in comments he made February 23, even if some White House opinion on the issue has been ambiguous. (Prior coverage .)

Practitioners question whether a cross-border reinsurance transaction under a border-adjustable tax would be taxable as an import of a service or not taxed as an export of risk. In a reinsurance agreement, an insurer assumes all or part of the risk undertaken originally by another insurer. In the global reinsurance market, U.S. insurers purchase reinsurance from both domestic and offshore insurance companies and offer reinsurance to domestic and foreign companies. U.S. foreign-owned insurance companies may establish reinsurance arrangements with their offshore affiliates.

In a global risk management industry, Congress may be challenged to superimpose an import-export analysis in order to draw lines where they shouldn't exist, according to Susan E. Seabrook of Buchanan Ingersoll & Rooney PC. Insurers intentionally move risks offshore for efficient shifting and distribution of risk, and therefore any restrictions or economic burdens that would tighten the market or make cross-border reinsurance more expensive would not be a good thing, she said.

A move to a cash-flow-based approach with border adjustability also raises numerous questions for the reinsurance market and more broadly the insurance industry because of statutory accounting rules and restrictions imposed by insurance regulations, coupled with a business model that is founded on the deductibility of reserves for income tax purposes, according to Seabrook.

The reinsurance business has been in the spotlight for nearly two decades as some policymakers have sought to curtail perceived tax avoidance and prevent disadvantaging domestic reinsurers. Previous legislative proposals focused on whether foreign-owned insurers that obtain reinsurance from offshore affiliate companies are in essence shifting U.S. income into tax havens, thereby placing domestic reinsurers at a competitive disadvantage. (Prior coverage .)

The IRS Statistics of Income division provides data on the offshore insurance market in its report on transactions between corporations and related foreign persons by industry for companies with more than $500 million in receipts. While the report notably excludes insurance and reinsurance agreements between those corporations and unrelated foreign persons, it provides a basic picture of trends within a segment of the industry.

The data show that the total premiums (insurance and reinsurance) paid by U.S. foreign-owned finance and insurance corporations to related foreign persons almost tripled from 2004 to 2012, increasing from $12.6 billion to $34.1 billion. In 2012, the latest year of available data, payments to Switzerland and Bermuda combined represented 65.4 percent of the total payments. As a percentage of the total payments, Bermuda's share increased from 11.1 percent in 2004 to 29.9 percent in 2012, compared to Switzerland's share, which decreased from 45.2 percent to 35.6 percent during that period.

The insurance and reinsurance premiums that those U.S. foreign-owned corporations received from related foreign persons was $6.3 billion in 2012, up from $4.2 billion in 2004, with Canada representing 52.4 percent of the total amount in 2012 and Ireland accounting for 29.3 percent.

David Schenck of PwC said there are regulatory and tax factors that go into where companies want to operate. Bermuda has the most favorable tax regime, and Switzerland "historically has had a very strong insurance business," Schenck said, explaining that while it is not part of the EU, it has a territorial system and a good treaty network.
Combine Switzerland's low, origin-based corporate tax rate with the country's "general status as a financial hub, and it makes sense why a lot of reinsurers want to locate there," said Alan Cole of the Tax Foundation.

In September 2016 House Ways and Means Committee member Richard E. Neal, D-Mass., and Senate Finance Committee member Mark R. Warner, D-Va., reintroduced legislation (S. 3424 ; House version H.R. 6270) that would disallow the deduction of nontaxed reinsurance premiums paid to foreign affiliates until the insured event occurs.

Cole said the border adjustment proposal works essentially the same way as previous offshore reinsurance proposals, but it's "more defensible" because it would apply to "everyone at once, not to a single industry."

Although the Democratic lawmakers' 2016 proposed bills and their predecessors focused on offshore affiliate arrangements, the destination-based cash flow tax under the blueprint, if applied to insurance companies, could also affect domestic insurers that obtain reinsurance from non-affiliate offshore companies. Premiums ceded to nonaffiliated offshore reinsurers, if treated as an import of a service, may no longer be deductible, but would have been under the proposal by Neal, now ranking member on Ways and Means.

Global Reinsurance Market

Seabrook argued that the concerns about tax avoidance in the offshore reinsurance context are misplaced "because you would not want to keep all of the hazardous disaster coverage, for example, in the U.S." It used to be that Bermuda's insurance industry "was not subject to sufficient regulations, but the regulatory regime has evolved, and the Bermuda market is very mature" and represents a real and thriving reinsurance business, she said.

Global reinsurance is particularly important in property and casualty insurance in part because the United States has seen a number of significant natural disasters or major loss events in the last 20 years, and global reinsurance disperses the impact of these losses, according to Jean Baxley of Deloitte Tax LLP. The United States avails itself of a substantial amount of reinsurance, she said, adding that data she has seen show that more than half of reinsured risks worldwide are U.S. risks.

In a December 2014 report, the Treasury Federal Insurance Office concluded that "global reinsurance providers play a vital role supporting insurance in the United States." According to Reinsurance Association of America data cited in the report, U.S. companies have steadily increased the share of their premiums ceded to non-U.S.-based reinsurers from 38 percent in 1997 to 62 percent in 2013.

"There are a lot of [tax reform] proposals floating around, and any changes to the taxation of reinsurance and particularly cross-border reinsurance will definitely have an effect on the larger reinsurance market and the availability of reinsurance options globally," Baxley said.

Import or Export?

Reinsurance involves a commission and a cession of premiums from the original insurer (the ceding company). The transferred risk can be measured as a dollar amount above a certain threshold (excess of loss reinsurance), or proportionally, as a certain percentage of each contract (quota share reinsurance). In some cases, a reinsurer may pay a premium to the ceding company, such as when premiums are expected to exceed claims. (Prior analysis.)

If reinsurance is deemed an imported service, insurance companies would no longer be allowed to deduct reinsurance premiums paid to offshore companies whether affiliated or not.

The first technical question under a border-adjustable tax is whether cross-border reinsurance would be an import of service or an export of risk, Seabrook said, adding that reinsurance is not a manufactured widget so it doesn't fit neatly into the import versus export characterization.

Baxley said that reinsurance is neither a typical service nor a manufactured good, but rather a contractual relationship with different treaty structures. "Arrangements between ceding and assuming companies, for example, may be on an indemnity or an assumption basis, may be proportional or nonproportional, and may include modified coinsurance and funds withheld features," she explained. It's unclear how definitions that are designed to address the taxation of goods and services would apply, for example, in determining under which circumstances a U.S. insurance company would be a net exporter versus a net importer of reinsurance, according to Baxley.

It will be interesting to see what the effects of viewing reinsurance as an inbound service would be, said Christopher Puglia of Deloitte Tax LLP. Alternatively, lawmakers could view reinsurance as an export of risk that could be important in deleveraging the economy, he said.

If a border adjustment tax is applied in the strictest sense -- reinsurance is treated as an imported service -- the insurance companies would pay higher taxes, Puglia said. Then, he said, a question would be, who would bear the economic burden of that tax: the importer or the customer? Or would U.S. insurers refrain from entering into foreign reinsurance contracts with foreign reinsurers, which would likely result in increased incentives to obtain reinsurance from domestic companies?

Insurers have argued that raising the tax cost of the transaction raises the overall costs of reinsurance and increases cost for consumers, Schenck said.

Would Reinsurance Remain Offshore?

Under a destination-based system, the United States would have no origin-based taxes, and therefore it would be a great place for reinsurance jobs, Cole said. For example, actuaries could be based in Miami instead of Bermuda, he said, adding that he's "not too concerned about the fate of the industry" if the House plan is implemented. Even though the change might make the "offshore model" not work as well, it makes the "option of locating in the U.S. a little better," according to Cole.

Schenck also said there are advantages for foreign-owned domestic and foreign businesses. Under border adjustability, foreign-owned businesses might decide to set up a U.S. subsidiary if the subsidiary's reinsurance of foreign risk would be an export, he said. If that's the case, there's a question of how, for example, the U.K. would treat it: whether there would be a deduction and whether it would be taxed anywhere.

However, border adjustability might not work to encourage insurance companies to reinsure in the United States because of other motivations, with practitioners highlighting some of the nontax business purposes for cross-border reinsurance.

Insurers may use affiliate reinsurance, for example, to move or consolidate a business into a particular entity; for regulatory purposes or administrative convenience; for balancing within a group; and to some degree, to minimize redundant capital, Seabrook explained. Insurers may purchase unaffiliated reinsurance to divest or acquire a line of business, she said.

Puglia stressed that "first and foremost, the reinsurance market and transactions are necessary for the economy and the overall industry to operate efficiently." Companies have to decide where they want to have those risks and where to locate those companies, he said. Several factors influence the decision, such as the jurisdiction's capital requirements and the ease of doing business and contracting, Puglia said, adding that taxation is only one element in the business decision.

U.S. insurance companies often cede lines of business or risk to reinsurance affiliates that would otherwise require a higher level of reserves under U.S. rules, thereby allowing companies to free up capital, Seabrook said. When insurance companies transfer a line of business generating losses, however, those losses may be trapped in the foreign jurisdiction, and the company may not be able to take advantage of the losses for U.S. tax purposes, she said.

Cash Flow Tax Issues

An issue with a cash flow approach to taxation is that the "deduction for insurance reserves is central to the current framework for insurance company taxation, so any cash flow approach would seem counterintuitive," according to Seabrook. Similarly, because statutory accounting is the foundation for insurance tax accounting, "it's difficult to imagine how a framework that completely ignores statutory accounting would be structured and implemented," she said.
It's often challenging to apply general corporate tax reform concepts to the insurance industry model characterized by premiums, reserves, and claims, according to Seabrook, who said, "Corporate tax reform proposals arbitrarily applied to the insurance industry are likely to create unintended consequences."

Insurance companies shouldn't be subject to tax solely on the basis of cash flow, Seabrook said, adding that they should be taxed over time as premiums, claim payments, and reserves offset each other.

Puglia explained that if an insurance company were taxed like other corporations, there wouldn't be matching of revenues and expenses because the insurance company would recognize income in year 1 and deductions in year 10. That approach could hurt the industry and substantially affect the availability of insurance, he said.

It's often difficult to determine how insurance fits into new tax laws and rules, and therefore a more substantive conversation about the industry is usually needed to determine appropriate tax treatment of insurers and reinsurers under a new regime, Puglia said.

With specifics so far lacking on the House plan, it's unclear how Congress might apply a destination-based cash flow approach to financial transactions, including cross-border reinsurance agreements. In discussing a different element of the blueprint -- no deduction for net interest expense -- the report states that the Ways and Means Committee will work to develop special rules for financial services companies, such as banks, insurance, and leasing, regarding interest expense.

In response to a question concerning how a border adjustment proposal would apply to that industry and whether cross-border reinsurance transactions would be treated as an import of a service or an export of risk, a spokesperson for the House Ways and Means Committee told Tax Analysts, "The chairman has said we are not generally contemplating a broad set of exemptions for different activities and products. We are working through how this will apply to the financial services industry."

The tax reform legislative process should include "a fulsome public debate and [be] designed in a bipartisan way," which could easily yield industry-specific rules, according to Mark Mazur, formerly Treasury assistant secretary for tax policy and now director of the Urban-Brookings Tax Policy Center. Leaving the rules to Treasury to develop regulations would be the wrong strategy, Mazur said. (Prior coverage.)

A person familiar with the congressional tax reform efforts said the legislation is expected to address the plan's application to the financial services industry, rather than being left to Treasury regulations.

According to Cole, "It's very plausible that eventually some number of financial services end up being kept out of the destination-based framework" because sometimes it is hard to apply the concepts to financial services. "A lot of value added taxes exempt financial services," Cole said, adding, "So it's possible we could end up with no change to the reinsurance industry" or just a corporate rate reduction.