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MEMORANDUM

From: Stuart E. Eizenstat
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Re: WTO-Consistency of Legislation to Disallow Deductions for Excess Reinsurance Premiums Paid to Affiliates

This memorandum explains the consistency of H.R. 3424, a bill introduced by Rep. Richard Neal of Massachusetts, with U.S. obligations under the General Agreement on Trade in Services (GATS) of the World Trade Organization (WTO).

Like many countries' tax laws, the U.S. federal income tax code is continually modified to counter and reduce tax avoidance. In anticipation of this, GATS expressly permits the adoption of measures designed to prevent tax avoidance, and acknowledges that such measures may involve differential treatment of foreign service suppliers without violating any WTO obligations.

The Neal bill seeks to close a significant loophole in the taxation of underwriting and investment income in the U.S. insurance industry. Premiums paid for reinsurance are generally deductible under current U.S. law. Exploiting this rule, primary insurers of U.S. risks escape U.S. income tax by paying reinsurance premiums to affiliated companies abroad, where the transferred premiums and related investment income are not subject to U.S. tax. The Neal bill aims to close this loophole by disallowing deductions for excess reinsurance premiums paid to affiliates.

As a direct tax measure based on objective criteria and designed to prevent erosion of the U.S. tax base, H.R. 3424 represents an exercise of sovereign U.S. authority that is affirmatively permitted by GATS and WTO rules.

Part I of this memorandum surveys the relevant principles and provisions of GATS, which explicitly protects the ability of WTO members to prevent tax avoidance and safeguard their domestic tax base. Part II describes the basic purposes and specific features of the Neal bill, which closes a loophole by limiting income tax deductions for

excess reinsurance premiums paid to affiliates. Part III then analyzes the consistency of the proposed legislation with GATS and WTO rules.

## I. Relevant GATS Provisions

In the Uruguay Round, signatories of the General Agreement on Tariffs and Trade (GATT) agreed to establish the WTO and to extend its disciplines beyond goods to new areas, including services. The drafters of GATS borrowed foundational principles from the GATT, such as most-favored-nation (MFN) treatment (which prohibits discrimination among WTO members) and national treatment (which prohibits discrimination between domestic and foreign service suppliers). Unlike in GATT, commitments to market access and national treatment in GATS do not apply across the board. Instead, WTO members make specific commitments to liberalize trade in services on a sector-by-sector basis.[1]

GATS also provides various general exceptions.[2] With respect to tax laws, for example, GATS allows members to derogate from MFN treatment pursuant to a treaty to avoid double taxation, and from national treatment to ensure the equitable or effective imposition or collection of direct taxes.[3] As with other exceptions, GATS requires that such tax measures not be "applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services."[4]

The United States service schedule includes a market access commitment for the cross-border supply of reinsurance.[5] In terms of national treatment, the United States must give reinsurance "services and service suppliers" from any WTO member "treatment no less favourable than" that it gives "its own like services and service suppliers" in the reinsurance sector.[6] Even if formally identical, any treatment that "modifies the conditions of competition" in favor of domestic reinsurers "shall be considered to be less favourable."[7]

This national treatment obligation, however, is limited by exceptions both specific and general. The specific limitation in the U.S. schedule is for a one per cent federal excise

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[1] GATS Arts. XVI and XVII.

[2] These exceptions allow members to restrict services trade in order to safeguard the balance of payments; protect public morals or maintain public order; protect human, animal or plant life or health; or protect essential national security interests. *See* GATS Arts. XII, XIV, and XIV bis.

[3] GATS Art. XIV(d) and (e).

[4] GATS Art. XIV.

[5] U.S. Schedule of Specific Commitments, Supplement 3, WTO Document GATS/SC/90/Suppl.3 (26 Feb. 1998), at 7.

[6] *See* GATS Art. XVII(1).

[7] *See* GATS Art. XVII(3).

tax on all reinsurance premiums paid to foreign companies to cover U.S. risks.[8] The general exception, from GATS Article XIV(d), allows differential treatment of domestic and foreign reinsurers if the tax measure at issue is "aimed at ensuring the equitable or effective imposition or collection of direct taxes."

The explicit exemption for direct tax measures that treat domestic and foreign suppliers differently was the subject of intensive bargaining in the final stages of the Uruguay Round.[9] Leaving as little as possible to chance, GATS negotiators included a detailed definition of "direct taxes" and a lengthy footnote cataloguing illustrative types of measures that unambiguously fall within the scope of Article XIV(d).

Direct taxes are defined in GATS as "all taxes on total income, on total capital or on elements of income or of capital, including taxes on gains from the alienation of property, taxes on estates, inheritances and gifts, and taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation."[10]

In considerable detail, a footnote to Article XIV(d) clarifies that measures "aimed at ensuring the equitable or effective imposition or collection of direct taxes include measures" that:

> (i) apply to non-resident service suppliers in recognition of the fact that the tax obligation of non-residents is determined with respect to taxable items sourced or located in the Member's territory; or
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> (ii) apply to non-residents in order to ensure the imposition or collection of taxes in the Member's territory; or
>
> (iii) apply to non-residents or residents in order to prevent the avoidance or evasion of taxes, including compliance measures; or
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> (iv) apply to consumers of services supplied in or from the territory of another Member in order to ensure the imposition or collection of taxes on such consumers derived from sources in the Member's territory; or

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[8] U.S. Schedule of Specific Commitments, Supplement 3, WTO Document GATS/SC/90/Suppl.3 (26 Feb. 1998), at 7.

[9] *See* John Croome, RESHAPING THE WORLD TRADING SYSTEM: A HISTORY OF THE URUGUAY ROUND 324 (2d ed. 1999) (noting that only on Dec. 10, 1993, after more than seven years of negotiations, "a complex agreement was announced that settled the taxation question by acknowledging the right to treat foreign and national service suppliers differently, provided certain conditions were met"); *see also id*. at 310-13, 320 (discussing late-stage negotiations).

[10] GATS Art. XXVII(o).

> (v) distinguish service suppliers subject to tax on worldwide taxable items from other service suppliers, in recognition of the difference in the nature of the tax base between them; or
>
> (vi) determine, allocate or apportion income, profit, gain, loss, deduction or credit of resident persons or branches, or between related persons or branches of the same person, in order to safeguard the Member's tax base.[11]

To highlight the deference that national systems deserve on these direct tax issues, the footnote further states that all "[t]ax terms or concepts" in Article XIV(d) and in the footnote should be "determined" not in accordance with international standards, but rather in accordance with "the domestic law of the Member taking the measure."[12]

When agreement was reached on the footnote to Article XIV(d), the chairman of the services talks issued a statement expressing the negotiators' common understanding of that provision.[13] The statement makes clear that "distinctions without a link to national origin and based on objective criteria would not normally violate national treatment," and that "[d]istinctions based on objective criteria would include . . . whether deductible payments can be used to erode the Member's tax base." The chairman adds that for there to be a violation, "any formally different treatment accorded would have to result in less favourable conditions of competition," but emphasizes that "[m]easures designed to ensure the neutrality or integrity of the taxation system can be viewed as ensuring that service suppliers, in the structuring of their transactions, do not benefit from conditions of competition more favourable than others in similar circumstances." Moreover, the statement notes that "very few tax measures affecting service suppliers would ever require justification under Article XIV," because "[m]ost tax measures providing distinct treatment to different categories of service supplier appear to deal with unlike service suppliers, to be based on objective considerations, or not in fact to accord less favourable conditions of competition." Finally, the chairman observes that "the listing in the footnote of measures which governments may find it necessary to take is without prejudice as to whether any of them would necessarily" violate national treatment.

## II. The Neal Bill, H.R. 3424

Under current law, companies insuring risks in the United States are typically allowed to deduct premiums paid for reinsurance.[14] The traditional purpose of reinsurance is to shift risk to unrelated entities, thereby reducing the concentration of a primary insurer's pool of risks, or limiting the insurer's exposure to a catastrophic event. For different reasons,

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[11] GATS Art. XIV(d), n.6.

[12] *Id*.

[13] Chairman's Statement, Informal GNS Meeting – 10 December 1993, WTO Document MTN.GNS/49 (11 Dec. 1993), at 1-2.

[14] I.R.C. § 832(b)(4).

primary insurers may also choose to reinsure part of their business with related entities—for example, to move capital across a group of affiliated companies, or to consolidate capital in a central location for efficient management. Yet another reason to reinsure U.S.-based risks with foreign affiliates, however, is to shift income overseas and thereby avoid or reduce U.S. tax liability—not only on deductible U.S.-origin premiums, but also on investment earnings from transferred reserve assets.

Companies that reinsure U.S.-based risks with foreign affiliates that are not subject to U.S. income tax raise the potential of unfairly eroding the U.S. tax base. Congress enacted legislation in 1984 and 2004 giving the Treasury Department authority to deal with this problem through transfer pricing rules.[15] Introducing his bill on the House floor, however, Rep. Neal noted the ineffectiveness of previous legislative attempts to limit "tax avoidance" through "excessive reinsurance between related entities."[16] According to Rep. Neal and the Joint Tax Committee staff's Technical Explanation of H.R. 3424, combating tax evasion was a principal reason for the proposed legislation.[17]

The Neal bill seeks to address the problem by disallowing deductions for excess reinsurance premiums that relate to U.S. risks and that are paid *to affiliated companies* not subject to U.S. income taxation. Affiliated companies are members of the same controlled group of corporations (using a 25% standard for cross-ownership, rather than an 80% test). The bill covers only insurance companies that are subject to taxes under section 831 of the Internal Revenue Code, which primarily means property and casualty insurers operating in the United States. It does not restrict *all* deductions for reinsurance premiums paid to affiliates. Instead, it disallows only *excess* deductions for premiums paid by covered companies to affiliated, non-taxed reinsurers—including, in certain circumstances, reinsurers controlled by U.S. shareholders.[18] Excess deductions are those that exceed the sum of (1) the premium limitation and (2) qualified ceding commissions on those premiums.

The premium limitation is determined for each covered insurer, separately with respect to each line of business that it operates, during each taxable year. In simple terms, the premium limitation reflects a comparison, for a particular line of business, between a primary insurer's level of reinsurance and the average amount of reinsurance in the industry. Under the proposed legislation, there is no limit on deductions for reinsurance

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[15] *See* I.R.C. § 845.

[16] U.S. House of Representatives, Extensions of Remarks, Rep. Richard E. Neal (July 31, 2009).

[17] *See* Technical Explanation of Bill to Amend the Internal Revenue Code of 1986 to Disallow the Deduction for Excess Nontaxed Reinsurance Premiums Paid to Affiliates ("Technical Explanation"), at 9 (noting that the bill "is structured to discourage reinsurance transactions that are likely to be motivated by avoidance of U.S. taxation").

[18] For example, the bill might limit deductions for premiums paid to an affiliated foreign reinsurer that is controlled by U.S. shareholders if its underwriting income is exempt from taxation under subpart F because of the high-tax exception of section 954(b)(4).

premiums paid to third parties. The bill only limits deductions for premiums paid to affiliated reinsurers in excess of industry averages.

The Neal bill also includes an election provision for affiliated foreign reinsurers. This provision enables a foreign affiliate, for any taxable year, to treat specified reinsurance income as effectively connected with the conduct of a trade or business in the United States and thus subject to U.S. income tax. By means of this election, the specified reinsurance income of the foreign affiliate is subject to the same tax treatment as similar income earned by U.S. reinsurers. For purposes of the election, specified reinsurance income means all non-taxed reinsurance premiums paid to the foreign affiliate by a covered company, as well as investment income that is allocable to those premiums.

The Neal bill was modeled on section 163(j) of the Internal Revenue Code, a longstanding provision that limits deductions for excess interest payments to related entities. The model U.S. tax treaty expressly preserves the right of the United States to tax excess interest payments between affiliated firms.[19] Like section 163(j), the Neal bill protects the domestic tax base by limiting "earnings stripping."

## III. Analysis of the Neal Bill Under GATS

*A. H.R. 3424 Does Not Violate National Treatment.*

As GATS negotiators recognized during the Uruguay Round, three conditions must be met before a tax measure constitutes a violation of national treatment: "the service suppliers must be 'like'; the distinct treatment must relate to the national origin of the service supplier; and the treatment must be less favourable."[20]

The Neal bill does not make eligibility to deduct reinsurance premiums depend on national origin. Both foreign and U.S. insurers writing policies for U.S. risks are eligible to claim deductions, for premiums paid to both foreign and U.S. reinsurers. The only limitation is on *excess* premiums paid to *affiliated* reinsurers (both foreign and U.S.-controlled) that do not pay U.S. income tax on those premiums.

As Uruguay Round negotiators recognized, a measure of this type simply ensures "that service suppliers, in the structuring of their transactions, do not benefit from conditions of competition more favourable than others in similar circumstances."[21] H.R. 3424 levels the playing field by limiting (but not closing) a loophole that enables certain firms to avoid taxation on underwriting and investment income related to U.S. risks. Moreover,

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[19] *See* "United States Model Income Tax Convention of November 15, 2006," *available at* <http://www.irs.gov/pub/irs-trty/model006.pdf>, Art. 11.5.

[20] Chairman's Statement, Informal GNS Meeting – 10 December 1993, WTO Document MTN.GNS/49 (11 Dec. 1993), at 1.

[21] *Id.*

the bill's election provision enables foreign affiliates to ensure that specified reinsurance income is subject to the same tax treatment as similar income earned by U.S. reinsurers.

As a general principle, GATS negotiators presumed that "distinctions without a link to national origin and based on objective criteria would not normally violate national treatment," and that "[d]istinctions based on objective criteria would include . . . whether deductible payments can be used to erode the Member's tax base." The Neal bill, which limits deductions for excess premiums paid to affiliates, is precisely such a measure.

Because the Neal bill does not draw distinctions based on national origin, levels the playing field between similarly situated reinsurers, and is based on objective criteria regarding the deductibility of payments that erode the U.S. tax base, it does not represent a violation of the U.S. commitment to provide national treatment to foreign reinsurers.

*B. H.R. 3424 Qualifies As a Permissible Exception from National Treatment.*

Even if the Neal bill violated national treatment, however, it still does not constitute a violation of WTO rules because the legislation qualifies as a permissible exception under GATS Article XIV(d). This tax provision has yet to be addressed in the context of a WTO dispute, but other Article XIV exceptions have been the focus of litigation. As interpreted by the Appellate Body, the WTO's highest judicial arm, GATS Article XIV "contemplates a 'two-tier analysis' of a measure that a Member seeks to justify under that provision."[22]

> The first step is to determine whether the measure falls within the scope of one of the paragraphs of Article XIV, in this case paragraph (d): Does the Neal bill constitute a measure aimed at ensuring the equitable or effective imposition or collection of direct taxes?
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> If so, the second step is to consider whether the measure satisfies the general requirements of Article XIV's chapeau, or introductory clause: Would the Neal bill be applied in a manner that constitutes a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services? If not, the measure does not violate GATS.

Because the proposed legislation meets these criteria, the Neal bill is WTO-consistent even if it imposes differential treatment on domestic and foreign reinsurers.

To demonstrate the consistency of H.R. 3424 with GATS, a threshold question is whether the Neal bill represents a direct tax measure. Under GATS, direct taxes "comprise all taxes on total income . . . or on elements of income."[23] The Neal bill is a federal *income*

[22] *US – Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, WTO Document WT/DS285/AB/R (7 April 2005) ("*US – Gambling*"), ¶ 292.

[23] GATS Art. XXVIII(o).

tax measure that limits deductions for certain excess reinsurance premiums. For covered insurers, those excess reinsurance premiums clearly constitute "elements of income" on which the Neal bill imposes taxes. The U.S. Supreme Court has ruled that income tax deductions are a matter of legislative grace, such that denial of a deduction cannot be construed as an indirect tax.[24] Moreover, the U.S. Internal Revenue Service (IRS) defines a direct tax as "[a] tax that cannot be shifted to others, such as the federal income tax," which is what the Neal bill seeks to amend.[25] These definitions in U.S. law, which are consistent with the definition in GATS, receive weight because footnote 6 to GATS Article XIV(d) states that tax terms or concepts are to be determined according to definitions in domestic law.

GATS does not define indirect taxes, but the traditional definition of an indirect tax is a tax on transactions, such as a sales, excise, value-added, or transfer tax.[26] The Neal bill is not comparable to an excise or sales tax on transactions. By its literal terms, the legislation regulates deductions in the context of the federal income tax. With regard to its practical effect, the Neal bill may result in increased tax only with respect to certain excess reinsurance transactions, not all reinsurance transactions, or even all reinsurance transactions with affiliated companies.

In short, the federal income tax is a quintessential direct tax, and the Neal bill limits deductions for certain excess reinsurance premiums—a quintessential element of income in the corporate income tax system. For these reasons, the Neal bill clearly qualifies as a direct tax measure under GATS.

As such a measure, is the Neal bill "aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other Members," and thus within the scope of Article XIV(d)? Footnote 6 provides an illustrative list of measures that indisputably fall within the scope of this provision.

- Among the listed measures are those that "apply to non-residents or residents in order to prevent the avoidance or evasion of taxes." As discussed, the legislative history makes clear that H.R. 3424 "is structured

[24] *See, e.g.*, *Comm'r of Internal Revenue v. Tellier*, 383 U.S. 687, 693 (1966) (holding that the "[d]eduction of expenses . . . may, to be sure, be disallowed by specific legislation, since deductions are a matter of grace and Congress can, of course, disallow them as it chooses") (internal quotation marks omitted).

[25] *See* "Understanding Taxes: Glossary," Internal Revenue Service, *available at* <http://www.irs.gov/app/understandingTaxes/student/glossary.jsp >.

[26] Footnote 58 of the WTO Agreement on Subsidies and Countervailing Measures defines "indirect taxes" as "sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges."

to discourage reinsurance transactions that are likely to be motivated by avoidance of U.S. taxation."[27]

- Other listed measures are those that "apply to consumers of services supplied in or from the territory of another Member in order to ensure the imposition or collection of taxes on such consumers derived from sources in the Member's territory." Insofar as covered insurers represent consumers of reinsurance services supplied by foreign affiliates with respect to U.S. risks, the Neal bill fits this category as well.

- Finally, and decisively, among the qualifying direct tax measures are those that "*determine*, allocate or apportion income, profit, gain, loss, *deduction* or credit . . . *between related persons* or branches of the same person, *in order to safeguard the Member's tax base*." The Neal bill determines the proper level of deductions for reinsurance premiums between related companies, and it does so for the express purpose of safeguarding the domestic U.S. tax base.

For all these reasons, H.R. 3424 clearly falls within the scope of GATS Article XIV(d) as a measure aimed at ensuring the equitable or effective imposition or collection of direct taxes.

The final step in the analysis is whether the Neal bill, as applied, would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services. Although the legislation has yet to be enacted, let alone applied, it is difficult to imagine that the Neal bill would fail to meet the requirements of Article XIV's chapeau.

As an initial matter, the negotiators of GATS shared a general presumption that direct tax "measures found to be justified under the footnote would normally be expected also to meet the requirement[s] in the chapeau to Article XIV."[28] This presumption operates strongly in favor of the Neal bill, given how clearly it fits within the illustrative list of permissible measures in the footnote to Article XIV(d).

The text and purpose of the Neal bill only reinforce the conclusion that it is neither unjustifiably discriminatory nor a disguised restriction on trade in services. The Appellate Body has explained that where, as here, the available evidence on application or enforcement is limited, it is proper to focus, "as a matter of law, on the wording of the measures at issue" for evidence of discrimination.[29]

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[27] *See* Technical Explanation, at 9.

[28] Chairman's Statement, Informal GNS Meeting – 10 December 1993, WTO Document MTN.GNS/49 (11 Dec. 1993), at 2.

[29] *US – Gambling*, ¶ 357.

The Neal bill, on its face, makes no distinction between U.S. and foreign ownership in determining whether to disallow certain deductions. Deductions are denied when reinsurance is used to shift income, at excessive levels, beyond the reach of U.S. income tax. Bilateral tax treaties allow differential tax treatment of U.S. and foreign persons based on differing, tax-relevant circumstances—such as when one, but not the other, is subject to U.S. income tax. Given that principle, any differential effects from the Neal bill would not rise to the level of arbitrary or unjustifiable discrimination. Moreover, the bill's election provision allows foreign affiliates to ensure that their reinsurance income is subject to the same tax treatment as similar income earned by U.S. reinsurers.[30]

Furthermore, the Neal bill involves no distinction whatsoever between WTO members, much less any arbitrary or unjustifiable discrimination between countries where like conditions prevail. The bill's limitation on deductions for excess reinsurance premiums paid to affiliates applies across the board to all excess premiums, without regard to the specific jurisdiction in which the affiliated reinsurer operates or is based.

Finally, the Neal bill does not provide a benefit to domestic industry; rather, it aims to level the playing field in the U.S. market by reducing (but not eliminating) an unfair advantage enjoyed by insurance companies affiliated with corporations that are not subject to U.S. income tax.

## IV. Conclusion

The Neal bill seeks to safeguard the U.S. tax base and prevent tax avoidance by limiting deductions for excess reinsurance premiums paid to affiliates beyond the reach of the U.S. income tax system. Direct tax measures enacted for such purposes are affirmatively permissible under GATS Article XIV(d). H.R. 3424 seeks to close an income tax loophole, based on objective criteria, in a manner anticipated by Uruguay Round negotiators and fully consistent with GATS.

[30] Critics of the bill allege that foreign affiliates who make the election will face a much larger U.S. tax burden than similarly situated U.S. reinsurers. These claims presume application of the 30% branch profits tax to foreign affiliates that make the election, but the basis of that presumption is unclear. In any event, the branch profits tax is not discriminatory; its aim is to reduce the disparities in treatment between U.S. and foreign corporations and between two business forms, subsidiaries and branches, through which foreign corporations operate in the United States. *See, e.g.*, Staff of the J. Comm. on Tax'n, 100th Cong. 1st Sess., General Explanation of the Tax Reform Act of 1986 (JCS-10-87), at 1036-37; S. Rep. No. 99-313, at 401-02 (1986); H.R. Rep. No. 99-426, at 432-33 (1985).