

**GAO**

Briefing Report to the Honorable  
Fortney (Pete) Stark, House of  
Representatives

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September 1989

# TAX POLICY

## The Insurance Excise Tax and Competition for U.S. Reinsurance Premiums





United States  
General Accounting Office  
Washington, D.C. 20548

General Government Division

B-233705

September 25, 1989

The Honorable Fortney (Pete) Stark  
House of Representatives

Dear Mr. Stark:

This briefing report responds to your request for information on the relationship between the Tax Reform Act of 1986 (the act) and competition between U.S. and foreign property/casualty reinsurers in the U.S. market. In the United States, these reinsurers provide insurance coverage to American insurance companies and help protect property/casualty insurers against economic loss. The report discusses

- the taxation of property/casualty reinsurers in the United States,
- whether the Tax Reform Act of 1986 has affected the competitiveness of U.S. reinsurers, and
- tax and non-tax issues that Congress may want to consider in dealing with a U.S. reinsurance industry proposal that would (1) increase the excise tax on premiums that go to foreign reinsurers who cover U.S. risks and (2) eliminate tax treaty provisions that waive the excise tax.

#### BACKGROUND

Domestic reinsurers are subject to U.S. income tax on their worldwide income. Foreign reinsurers that do not have a U.S. office or agent may be taxed in their own countries but are not ordinarily subject to U.S. income tax on their U.S. premium income. Instead, section 4371 of the Internal Revenue Code imposes an excise tax on premiums paid to foreign insurers and reinsurers. The excise tax, which is currently waived in 10 of the 55 tax treaties the United States has with foreign countries, is levied at the rate of 1 cent on each dollar paid for a policy issued by a foreign reinsurer. The excise tax is also levied at the rate of 1 cent on each dollar paid to a foreign insurer for a life insurance policy, and 4 cents on each dollar paid to a foreign insurer for an insurance policy covering property/casualty risks.

operating out of foreign countries may have to cope with a similar burden on the basis of the tax laws in their own jurisdictions. Also, American reinsurers only pay U.S. income tax if they have an operating gain. Aside from tax treaty waivers, the premiums received by foreign reinsurers are subject to the excise tax regardless of gains or losses.

- Do foreign reinsurers complement U.S. reinsurers and provide coverage that is not normally available or affordable in the U.S. market?

U.S. consumers of reinsurance assert that they are sometimes forced to turn to the international reinsurance market because domestic reinsurers are unwilling to reinsure some types of coverage.

- Who bears the burden of the excise tax on reinsurance premiums--U.S. consumers or foreign reinsurers?

If coverage is not available from domestic reinsurers, foreign reinsurers are better able to pass the burden of the tax to consumers in the form of higher reinsurance premiums. If coverage is available from U.S. and foreign reinsurers, American consumers can switch to U.S. companies in an attempt to escape the tax burden. Their success in avoiding the tax depends on market conditions, such as the degree of price competition.

- Would an increased excise tax be perceived as a barrier to entry into the U.S. reinsurance market and would it be compatible with recent efforts to liberalize trade?

An increase in the excise tax, coupled with the elimination of excise tax treaty waivers, may encourage foreign countermeasures, jeopardizing the ability of U.S. insurers to compete in other markets.

See appendix I for more details.

#### OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of our work was to examine, in light of the Tax Reform Act of 1986, the relationship between (1) the competitiveness of U.S. and foreign reinsurers in the U.S. market and (2) the excise tax on U.S. premiums that go to foreign reinsurers. To do our work, we reviewed U.S. and

C O N T E N T S

		<u>Page</u>
LETTER		1
APPENDIX		
I	Property/Casualty Insurance and Reinsurance	8
	Taxation of Reinsurers in the United States	10
	Tax Reform Act of 1986: Industry-Specific Changes	12
	Tax Reform Act of 1986: Corporate Changes	14
	Industry Studies on the Impact of Tax Reform	16
	RAA's Assertions About Foreign Competition	18
	RAA's Proposals to Restore the Competitive Balance	20
	Has Tax Reform Affected U.S. Reinsurance Market Share?	22
	Should the Current Excise Tax Policy Be Changed?	24
	What Other Factors Influence a Reinsurer's Tax Position?	26
	Do Foreign Reinsurers Complement the U.S. Industry?	28
	Who Bears the Burden of an Increased Excise Tax?	30
	Would Excise Tax Changes Be Viewed as Trade Restrictions?	32
II	1987 Net U.S. Premiums Paid to Reinsurers From Countries With U.S. Tax Treaties That Waive the Insurance Excise Tax	34
III	Objective, Scope, and Methodology	35
IV	Major Contributors to This Report	37
TABLE		
I.1	Net Premiums Paid to U.S. and Foreign Reinsurers on the Coverage of U.S. Risks	22



PROPERTY/CASUALTY INSURANCE AND REINSURANCE

Property and casualty insurance is a means of spreading financial loss or risk sustained by a relative few among many who buy this type of insurance. A contract is made between the insurer, who indemnifies, and the insured, who pays a premium for the contract. Property insurance provides financial protection against loss or damage to real and personal property, such as a home or automobile. Casualty insurance, which includes worker's compensation and automobile liability insurance, is concerned primarily with the insured's legal liability for injuries to others or for damage to other people's property.

To reduce the risk of having to pay for large or catastrophic losses, insurance companies occasionally cede or transfer some or all of their property/casualty risks to another insurer, called a reinsurer. In doing so, the insurer remits a premium to the reinsurer that can cover either individual risks or a group of risks. When a loss occurs, the reinsurer reimburses the insurer for the paid losses that are covered by the reinsurance contract. Thus, among other things, reinsurance (1) limits the primary insurer's liability for a particular loss or a group of losses and (2) expands the capacity or maximum volume of business the insurer is prepared to accept. In regard to the latter, reinsurance supplements surplus and helps to improve the insurer's financial position. As a result, reinsurance lessens or removes the need for the insurer to raise additional capital through financial markets.

Insurers purchase reinsurance from either domestic or foreign organizations in which the principal business is to sell reinsurance, or from insurance companies that operate reinsurance departments. Reinsurance is also purchased by reinsurers for the same reasons as primary insurers, such as protection against catastrophic losses. Transactions among reinsurers are called retrocessions and frequently occur on the world reinsurance market, especially in Bermuda, the United Kingdom, and some other European nations.

In its June 19, 1989, edition, National Underwriter, a newspaper on property and casualty insurance and risk and benefits management, reported that during 1988 the U.S. reinsurance market generated an estimated \$21.8 billion in net premiums. The publication also reported that, of these net premiums, U.S. professional reinsurers sold about \$11.1 billion (51 percent) and the U.S. reinsurance departments of primary companies sold about \$2.3 billion (10.4 percent). Preliminary data supplied to National Underwriter by the Bureau of Economic Analysis, Department of Commerce, indicated that foreign reinsurers were paid about \$8.4 billion (38.6 percent) on sales to U.S. insurers.

TAXATION OF REINSURERS IN THE UNITED STATES

Under section 832 of the Internal Revenue Code, U.S. reinsurers are taxed similarly to other U.S. business enterprises. Premium income is analogous to the sales receipts of other business taxpayers, and the claims paid are similar to other companies' cost of doing business. A difference is that claims payments on some risks may not be made until a future year, while the premiums for those risks may be received currently.

Domestic reinsurers are subject to federal tax on their worldwide income. Similarly, sections 842 and 882 of the Code apply U.S. income tax to the receipts of foreign reinsurers when that income is "effectively connected" with a U.S. trade or business. However, foreign reinsurers are not ordinarily viewed as engaged in a U.S. trade or business and are not subject to U.S. income tax if they have no U.S. office or agent. Instead, Code section 4371 imposes an excise tax at the rate of 1 cent on each dollar of premium paid on reinsurance contracts that cover U.S. risks. An excise tax is also imposed on premiums paid to foreign insurers for life insurance and property/casualty insurance at the rates of 1 cent and 4 cents per premium dollar, respectively. In 1987, the Internal Revenue Service collected about \$115 million in insurance excise tax revenue. We could not determine how much of this revenue was due to reinsurance alone.

All insurance excise taxes are currently waived in 10 of 55 tax treaties the United States has with foreign countries. Data collected by the Bureau of Economic Analysis, Department of Commerce, show substantial variations in net premiums paid to companies in the 10 treaty countries. For example, during 1987, net premiums paid to reinsurers from Bermuda and the United Kingdom totaled about \$2.9 billion and \$1.8 billion, respectively. In contrast, net premiums paid to reinsurers in Cyprus, Hungary, Romania, and the Soviet Union were less than \$500,000. Appendix II lists the 10 treaty countries and the net premiums paid to reinsurers in those countries for 1987.

Among other things, the excise tax waiver helps prevent double taxation, which can occur if the United States and its treaty partners have overlapping authority to impose and collect taxes on the same income. Like the United States, most treaty partners tax the income of resident insurers or reinsurers. However, two countries, Bermuda and Barbados, have excise tax treaty waivers but do not tax the premium income of resident insurers or reinsurers. This combined effect of no income tax and an excise tax waiver raised congressional concern that these insurers and reinsurers could realize a tax advantage on their U.S. business. Thus, Congress required that the waiver end on January 1, 1990, for both Bermuda and Barbados.

TAX REFORM ACT OF 1986: INDUSTRY-SPECIFIC CHANGES

The Tax Reform Act of 1986 contained several provisions that specifically broadened the taxable income base of the property/casualty insurance industry. These changes affected the taxation of both U.S. property/casualty insurers and reinsurers.

One of the more significant of these base-broadening changes is the treatment of loss reserves, or the amounts set aside to pay reported claims, future claims, and costs associated with such claims. Before 1987, insurers and reinsurers could deduct loss reserves from revenues at their full-valued level. Under the 1986 act, companies must discount loss reserves to present value levels before they can take the deduction.

Another major tax law change that affected the property/casualty insurance industry is called the revenue offset provision. This provision affected the taxation of a company's unearned premium reserve, which is a fund set aside to cover the portion of premiums that are paid in advance for insurance that is not yet provided. Before the act, the entire annual change in a company's unearned premium reserve was taken into account as a deduction when the company computed its taxable income. Now, each company can only deduct 80 percent of the yearly increase in unearned premiums.

One other major change affects the industry's deduction of reserves with regard to investment income from tax-exempt bonds or dividends. Under prior law, property/casualty insurers were not required to reflect the fact that deductible reserves may be funded in part from tax-exempt interest or dividends eligible for the dividends-received deduction. Now, companies must reduce the deduction for losses incurred by 15 percent of the tax-exempt interest income and the deductible portion of dividends received during the tax year.



TAX REFORM ACT OF 1986:  
GENERAL CORPORATE CHANGES

The Tax Reform Act of 1986 contained provisions that apply to all corporations, including property/casualty insurers and reinsurers. One prominent change was a decrease in the maximum corporate tax rate from 46 percent under the old law to 34 percent in 1988. Another major change that affected these insurers was an increase in the capital gains tax rate from 28 percent to 34 percent. Finally, the property/casualty insurance industry, like other industries, is subject to provisions that broadened or strengthened the alternative minimum tax.

INDUSTRY STUDIES ON THE  
IMPACT OF TAX REFORM

Insurance industry representatives assert that the Tax Reform Act increased the property/casualty industry's tax burden. In a March 1988 study entitled The Effects of the 1986 Tax Reform Act on the Property/Casualty Insurance Industry, the Insurance Services Office, Inc. (ISO), analyzed the impact of the act on U.S. reinsurers. ISO projected that, during 1988 and 1989, reinsurers would have received a tax refund of about \$100 million had the old law still applied. However, with passage of the act, ISO estimated that reinsurers would be liable for about \$300 million in federal income taxes. ISO attributed most of the \$400 million in additional tax burden to loss reserve discounting.

The Reinsurance Association of America (RAA) maintains that the act had a significant impact on U.S. reinsurers. In a study entitled The Impact of the Tax Reform Act of 1986 on U.S. Property-Casualty Reinsurance Companies, RAA estimated that reinsurance premiums would have to be increased 7.3 percent in order to cover the additional tax liability under the act. RAA also reported that, if reinsurers do not increase premiums, their profit margin will decline by 13.86 percent. RAA attributes the increased tax liability and the corresponding decline in profit margins to discounting of loss reserves.

RAA'S ASSERTIONS ABOUT FOREIGN COMPETITION

U.S. insurers and reinsurers often rely on world markets to help reinsure U.S. property/casualty risks. RAA is concerned that the Tax Reform Act will force U.S. companies to look more closely at the international reinsurance market because foreign reinsurers will be in a better position to provide less expensive coverage.

RAA believes that parity existed before the act because, without loss reserve discounting, the effective federal tax burden on American reinsurers was negligible. The domestic reinsurers believe that this fostered parity because, in their view, foreign reinsurers are generally not subject to significant income taxes in their own countries. In the absence of a tax treaty waiver, a foreign reinsurer's U.S. tax liability is limited to the insurance excise tax, which is levied at the rate of 1 cent for each premium dollar.

RAA maintains that tax reform created a competitive imbalance because the act only affected domestic reinsurers. The Association believes that increased taxes will force U.S. reinsurance companies to either raise premiums and lose market share to foreign companies or maintain premiums at pre-tax reform levels with a corresponding loss in profit margin.

RAA'S PROPOSALS TO RESTORE THE COMPETITIVE BALANCE

Because of its concern that tax reform has created disparities in the tax treatment of U.S. and foreign reinsurers, RAA has advanced a proposal designed to restore parity in the U.S. market. RAA's proposal would (1) increase the excise tax on reinsurance premiums from 1 percent to 4 percent on each premium dollar collected by foreign reinsurers and (2) eliminate the provisions of tax treaties that waive the excise tax.

RAA contends that, if its proposal were adopted, the pre-tax reform competitive balance between domestic and foreign companies would be restored. Its proposal does not address the excise tax or treaty provisions pertaining to life insurance and direct property/casualty insurance.

HAS TAX REFORM AFFECTED U.S.  
REINSURANCE MARKET SHARE?

Because of RAA's concern about foreign competition in the U.S. reinsurance market, we attempted to examine how the Tax Reform Act might have affected the market. Available data show an increase in the share of the market garnered by foreign reinsurers in 1987 and 1988. However, it may be premature to attribute this increase to tax reform since foreign market share has been equally high in other years.

Table I.1 shows the percent of net U.S. reinsurance premiums paid to foreign reinsurers between 1960 and 1988. The table, based on data from National Underwriter, illustrates that, over the 29-year period, the percent of premiums paid to foreign reinsurers fluctuated between 26.1 percent and 43.2 percent, averaging about 31.8 percent. In recent years, the percent of reinsurance placed abroad rose from 26.1 percent in 1986 to 32.6 percent in 1987. For 1988, preliminary estimates based on data from the Bureau of Economic Analysis, Department of Commerce, suggest that the percent of reinsurance premiums transferred overseas increased to about 38.6 percent.

Although 1987 and 1988 showed sizable increases in the percent of reinsurance paid to reinsurers overseas, ascribing a cause-and-effect relationship between tax reform in 1986 and the change in reinsurance market share may be premature. This is because market share data for earlier years showed equal or greater activity by foreign reinsurers. For example, the share of net premiums paid to foreign reinsurers during the 1960s ranged from 34.1 percent to 43.2 percent, averaging about 37.4 percent over the 10-year period. Likewise, the percent of reinsurance paid to foreign reinsurers during 1980 and 1981 was 30.8 percent and 31.6 percent, respectively.

According to National Underwriter, tax reform has benefited foreign reinsurers at the expense of the domestic industry because U.S. reinsurers would probably lose business if they raised prices to offset additional taxes. However, the publication also pointed out that the increase in premiums received by foreign reinsurers for 1988 may be partly due to better data and improved survey techniques by the Department of Commerce, which annually surveys U.S. insurers and reinsurers about their transactions with foreign reinsurers. A Commerce official verified that some of the increase may be due to improved data collection but cautioned that Commerce's 1988 data is preliminary and may change as more data are collected.

SHOULD THE CURRENT EXCISE  
TAX POLICY BE CHANGED?

Several questions should be considered in any deliberations about whether current insurance excise tax policy should be changed.

- What other factors influence a reinsurer's relative tax position in the U.S. market?
- To what extent do foreign reinsurers complement the U.S. industry by providing coverage not affordable or available in this country?
- Who bears the burden of the excise tax on reinsurance premiums--U.S. consumers or foreign reinsurers?
- Would an increase in the excise tax be perceived as a barrier to entry into the U.S. market?

WHAT OTHER FACTORS INFLUENCE  
A REINSURER'S TAX POSITION?

Among other things, the insurance excise tax, first enacted in 1918, is supposed to mitigate tax disparities between U.S. reinsurers, who are subject to U.S. tax on their worldwide income, and foreign reinsurers, who are not taxed by the United States on income from the reinsurance of U.S. risks. However, various factors aside from the excise tax can influence a reinsurer's relative tax position in the U.S. market.

One factor that can influence a reinsurer's tax posture is the tax treatment of operating gains or losses. Aside from tax treaty waivers, the premiums received by a foreign reinsurer are subject to the excise tax on U.S. premium income regardless of whether the reinsurer has an overall operating gain or loss. In contrast, a U.S. reinsurer pays income tax only if the company has an operating gain. If an American company has an operating loss, the company pays no tax. Instead, a U.S. reinsurer may apply such losses to past taxable income to generate refunds, or carry them forward to apply against future tax liabilities.

The tax treatment of a foreign reinsurer in its own jurisdiction can also influence a reinsurer's relative tax position. Because of differences in the way the various countries define taxable income, we could not compare the tax burden of reinsurers from different countries. However, information compiled by the Office of the Assistant Secretary for Tax Policy, Department of the Treasury, on the tax treatment of reinsurers in their own countries shows that, for the nine countries studied, reinsurers were subject to a variety of tax laws, which may or may not affect their tax standing in relation to their U.S. counterparts. These variations, in combination with the excise tax, could affect a company's tax burden and the extent to which it is advantaged or disadvantaged on its U.S. business.

For instance, the Treasury data show that, excluding state and local income taxes, the U.S. taxes earned premium income at a rate of 34 percent and requires that loss reserves be deducted at a discounted value. In contrast, among the countries with the excise tax waiver, the United Kingdom and France tax similar types of premium income at the rate of 35 percent and 45 percent, respectively, but do not require loss reserve discounting. Sweden, which does not have an excise tax waiver, requires loss reserve discounting and taxes premiums at a 52-percent rate. Unlike the United States, Sweden and France allow reinsurers to deduct reserves set aside for catastrophes, which can be used to offset higher taxes on premium income. Moreover, France allows a tax deduction for gains and losses on currencies.

DO FOREIGN REINSURERS  
COMPLEMENT U.S. REINSURERS?

Another question that should be considered is the extent to which foreign reinsurers complement the U.S. reinsurance market by providing coverage otherwise not available or affordable. For example, the Vice President for Taxes at the Mortgage Guaranty Insurance Corporation (MGIC) told us that his company was forced to turn to the foreign reinsurance market because U.S. reinsurers considered MGIC's business undesirable. He said that in late 1983 and 1984 MGIC was approaching the point at which it no longer could take on new business due to a severe shortage of capital. The insurer, which protects banks and savings and loans from losses when homeowners fail to meet mortgage payments, was unable to raise new capital through the financial market. As an alternative, MGIC turned to the reinsurance market in mid-1984. The MGIC official told us that none of the domestic reinsurers MGIC approached expressed any serious interest in the company's business because they considered the risk associated with mortgage guaranty insurance unattractive. Subsequently, MGIC signed reinsurance agreements with insurance companies based in France, Sweden, Switzerland, and West Germany.

In a memo describing MGIC's reinsurance dilemma, MGIC officials told us that:

"By assuming risks considered undesirable by domestic reinsurers, foreign reinsurers play an important role in the volatile domestic insurance industry, as MGIC's experience demonstrates. This important resource for domestic insurers unable to distribute risks through arrangements with domestic reinsurers should not be further restricted by increasing the excise tax."

The Risk and Insurance Management Society (RIMS) also opposes a change in excise tax policy. RIMS represents over 4,000 corporate, governmental, and non-profit insurance consumers and is a clearinghouse for information on risk management. Its General Counsel told us that, besides taxes, factors such as the availability and cost of coverage and insurance-related services, regulatory requirements and exchange rates all affect the competitiveness of the U.S. insurance industry. He said that foreign reinsurers tend to complement domestic reinsurers because they increase the American insurance industry's capacity to provide more and broader types of insurance coverage. He also pointed out that foreign reinsurers are sometimes more willing to reinsure riskier lines such as product liability and environmental hazards, and have the underwriting expertise to provide more innovative reinsurance coverage.



WHO BEARS THE BURDEN OF AN  
INCREASED EXCISE TAX?

The availability of reinsurance coverage also raises questions about who would bear the burden of an increase in the excise tax. We do not know the extent to which taxes affect reinsurance premiums, but if coverage is not available from domestic reinsurers, foreign reinsurers are better able to pass the burden of the excise tax to customers in the form of higher reinsurance premiums. If a particular line of reinsurance coverage is available from U.S. and foreign reinsurers, American reinsurance consumers can switch to U.S. companies in an attempt to escape the burden of the excise tax. In either case, the extent to which consumers can successfully avoid the tax depends on market conditions, such as the degree of price competition.

While discussing the difficulty in obtaining reinsurance to cover their risks in the U.S. market, MGIC officials stressed their concern that MGIC would bear the burden of an increased excise tax because MGIC cannot purchase a comparable product from U.S. reinsurers. Company officials calculated that, on the basis of MGIC's 1989 business plan, increasing the excise tax and eliminating tax treaty waivers would increase MGIC's excise tax bill from about \$1.5 million to approximately \$6.5 million.

WOULD EXCISE TAX CHANGES BE  
VIEWED AS TRADE RESTRICTIONS?

Another question to consider is how changes to the current policy regarding the insurance excise tax would coincide with recent efforts to liberalize trade worldwide and how those changes might be perceived by U.S. trading partners. Officials with the International Trade Administration in the Department of Commerce told us that, as part of the General Agreement on Trade and Tariff (GATT) negotiations, the United States has promoted talks on the liberalization of trade in the service industries. Although the U.S. thrust does not specifically cover taxes or insurance, a change regarding the insurance excise tax could be incompatible with the U.S. effort if the tax is perceived by U.S. trading partners as a barrier to entry into the U.S. market.

Another consideration relates to the unification of the European Economic Community (EEC). As part of this effort, EEC members are attempting to liberalize internal trade restrictions within the community, which, among other things, could result in a harmonization of insurance laws and regulations. Commerce officials pointed out that a unified EEC could react more effectively to a perceived trade barrier and could reciprocate by erecting barriers against U.S. companies. Thus, U.S. reinsurers might encounter greater difficulty competing in the European market.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of our work was to examine, in light of the Tax Reform Act of 1986, the relationship between (1) the competitiveness of U.S. and foreign reinsurers in the American market and (2) the excise tax on U.S. premiums that go to foreign reinsurers. Our work covered the U.S. property/casualty reinsurance market and included U.S.-based and foreign-based reinsurers that take on U.S. risks. We did not look at foreign reinsurance markets or the activity of U.S. reinsurers in those markets. For purposes of this report, a domestic reinsurer refers to a U.S.-based company that takes on U.S. risks and is organized in the United States. A foreign reinsurer is one that takes on U.S. risks but resides outside the United States.

To do our work, we (1) examined applicable U.S. and foreign tax laws, (2) reviewed reports and studies on the effects of the Tax Reform Act of 1986 on the property/casualty insurance industry, and (3) examined data on the U.S. reinsurance market. To examine foreign tax laws, we reviewed information published in a series of Price Waterhouse guides on the business conditions in the countries in which Price Waterhouse firms have offices or carry out work, including Japan, Germany, and the United Kingdom. We also obtained data on the taxation of property/casualty insurers, including reinsurers, from RAA and the Office of the Assistant Secretary for Tax Policy, Department of the Treasury. We did not verify the adequacy or accuracy of the data obtained from Price Waterhouse, RAA, or Treasury.

To look at the effects of the act on the property/casualty industry, we used the following analyses:

- The Effects of the 1986 Tax Reform Act on the Property/Casualty Insurance Industry was published in March 1988 by Insurance Services Office, Inc. (ISO), a non-profit corporation that makes available advisory rating, actuarial, statistical, policy form, and related services to any property/casualty insurer. ISO's analysis was based on 1986 and 1987 data obtained from A.M. Best, a source of financial data on the property/casualty industry.
- The Impact of the Tax Reform Act of 1986 on U.S. Property/Casualty Reinsurance Companies was provided by RAA in September 1988. RAA developed an actuarial model to compare premiums, losses, expenses, investment income, and taxes under the old and new tax laws.

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We did not test the adequacy or accuracy of the data in either of these analyses.

To examine the U.S. reinsurance market, we used studies published by the Bureau of Economic Analysis, the Department of Commerce, and the National Underwriter. The Commerce Department data were based on its Annual Survey of Reinsurance and Other Insurance Transactions By U.S. Insurance Companies With Foreign Persons, which is used to obtain information on transactions between U.S. insurance companies and foreign persons. In 1987 and 1988, Commerce surveyed about 1,600 U.S. insurers and reinsurers. Commerce received responses from 350 insurers and reinsurers that had transactions with foreign persons in excess of Commerce's \$1 million reporting threshold. The National Underwriter data were based on its Annual Survey of the United States Reinsurance Market, done by Standard & Poor's Insurance Rating Service. The National Underwriter also used the Commerce data to show the amount of U.S. reinsurance premiums that go to foreign reinsurers, and to develop estimates on U.S. market share taken by foreign reinsurers. We did not test the adequacy or accuracy of the data reported by Commerce, the National Underwriter, or Standard and Poor's Rating Service.

To further obtain information on the competitiveness of the U.S. reinsurance industry after the Tax Reform Act of 1986, we spoke with Treasury, Internal Revenue Service, and Commerce officials. We also spoke with representatives of RAA; MGIC; the Insurance Information Institute; the National Association of Surplus Lines Offices; the Risk and Insurance Management Society; the National Association of Insurance Brokers, Inc.; the Association of British Insurers; and Lloyd's of London. We did not verify information obtained from these organizations.

Our work was done from November 1988 through June 1989 and in accordance with generally accepted government auditing standards.



1987 NET U.S. PREMIUMS PAID TO REINSURERS  
FROM COUNTRIES WITH U.S. TAX TREATIES  
THAT WAIVE THE INSURANCE EXCISE TAX  
(Dollars in millions)

<u>Country</u>	<u>U.S. reinsurance premiums paid to foreign reinsurers</u>
Barbados	\$ 343
Bermuda	2,489
Cyprus	0
France	160
Hungary	a
Italy	33
Malta	a
Romania	a
USSR	a
United Kingdom	1,909

<sup>a</sup>Reinsurance premiums on the coverage of U.S. risks totaled less than \$500,000.

Source: Data used in the preparation of this chart obtained from the Office of the Assistant Secretary for Tax Policy, Department of the Treasury, and the Bureau of Economic Analysis, Department of Commerce.

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**GAO**    **Would Excise Tax Changes Be Viewed as Trade Restrictions?**

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As part of future GATT negotiations, the U.S. is promoting liberalization of trade in services.

Europe is ending trade barriers among EEC countries--unified body could make it more difficult for U.S. firms to compete in Europe.

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## GAO Who Bears the Burden of an Increased Excise Tax?

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Excise tax burden hinges on the availability of alternatives.

- If coverage is not available from U.S. companies, foreign reinsurers are better able to pass on the burden.
  - If coverage is available from U.S. reinsurers, consumers can switch to U.S. companies in an attempt to avoid the burden.
-

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**GAO** Do Foreign Reinsurers  
Complement the U.S. Industry?

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U.S. companies may have difficulty obtaining reinsurance on some domestic risks.

- **Affordability.**
- **Availability.**

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## GAO What Other Factors Influence a Reinsurer's Tax Position?

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Among other things, the excise tax is supposed to mitigate tax disparities, but certain factors can influence its effectiveness.

- Tax treatment of operating gains or losses in the U.S.
  - Tax treatment of foreign reinsurers in their own jurisdictions.
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# GAO Should the Current Excise Tax Policy Be Changed?

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Underlying issues:

- What other factors influence a reinsurer's tax position?
  - Do foreign reinsurers complement the U.S. industry?
  - Who bears the tax burden?
  - Would changes be perceived as restraints on trade?
-

# GAO Has Tax Reform Affected U.S. Reinsurance Market Share?

Table I.1:

Net Premiums Paid to U.S. and Foreign Reinsurers on the Coverage of U.S. Risks  
(Dollars in millions)

<u>Year</u>	<u>Paid to U.S. reinsurers</u>	<u>Paid to foreign reinsurers</u>	<u>Total U.S. market</u>	<u>Percent paid to foreign reinsurers</u>
1960	\$ 608	\$ 462	\$ 1,070	43.2
1961	658	461	1,119	41.2
1962	790	470	1,260	37.3
1963	827	550	1,377	39.9
1964	915	499	1,414	35.3
1965	984	510	1,494	34.1
1966	1,069	583	1,652	35.3
1967	1,084	608	1,692	35.9
1968	1,124	670	1,794	37.3
1969	1,339	700	2,039	34.3
1970	1,605	714	2,319	30.8
1971	1,844	735	2,579	28.5
1972	2,104	767	2,871	26.7
1973	2,412	920	3,332	27.6
1974	2,775	1,014	3,789	26.8
1975	3,423	1,221	4,644	26.3
1976	4,288	1,528	5,816	26.3
1977	5,351	2,028	7,379	27.5
1978	6,287	2,248	8,535	26.3
1979	6,333	2,356	8,689	27.1
1980	6,644	2,961	9,605	30.8
1981	6,989	3,227	10,216	31.6
1982	7,469	3,018	10,487	28.8
1983	7,698	3,194	10,892	29.3
1984	8,637	3,305	11,942	27.7
1985	11,255	4,625	15,880	29.1
1986	15,102	5,333	20,435	26.1
1987	15,151	7,335	22,486	32.6
1988	\$13,355	\$8,400 <sup>a</sup>	\$21,755	38.6

Source: National Underwriter, June 19, 1989.

<sup>a</sup>Net premiums paid to foreign reinsurers for 1988 is an estimate made by Standard & Poor's Insurance Rating Service for National Underwriter. The estimate is based on preliminary data collected by the Department of Commerce.

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**GAO RAA's Proposals to Restore  
the Competitive Balance**

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**Increase the excise tax on  
reinsurance from 1% to 4%.**

**Eliminate excise tax treaty  
waivers.**



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**GAO RAA's Assertions About  
Foreign Competition**

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Higher tax bill puts American reinsurers at a disadvantage in the U.S. market because foreign reinsurers are not subject to same tax treatment.

U.S. reinsurers that raise rates will lose market share.

U.S. reinsurers that maintain pre-tax reform premiums will suffer a loss in profit margins.

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## GAO Industry Studies on the Impact of Tax Reform

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The Insurance Services Office estimates that tax reform will increase the reinsurance industry's tax burden by \$400 million during 1988 and 1989.

The Reinsurance Association of America estimates that reinsurers will need to increase rates 7.3% to cover the additional tax.

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## GAO Tax Reform Act of 1986: Corporate Changes

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The p/c industry was also affected by overall corporate tax law changes.

- Decreased maximum corporate income tax rate--46% to 34%.
  - Increased capital gains tax rate--28% to 34%.
  - Broadened provisions for the alternative minimum tax.
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## GAO Tax Reform Act of 1986: Industry-Specific Changes

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Three major industry-specific tax law changes broadened the p/c industry's tax base.

- Deduct loss reserves at discounted value.
  - Tax 20% of increase in unearned premium reserve.
  - Prorate a portion of tax-exempt income.
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# GAO Taxation of Reinsurers in the United States

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U.S. companies pay tax on their worldwide income.

Foreign reinsurers that have no U.S. office or agent ordinarily do not pay U.S. income tax, but a 1% excise tax is levied on premiums.

- 10 tax treaties waive the excise tax.
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# GAO Property/Casualty Insurance and Reinsurance

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Property/casualty insurance protects the insured against financial loss.

Reinsurance protects the insurer against large or catastrophic losses.

- Lessens the insurer's liability.
  - Expands the insurer's capacity to assume more risk.
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ABBREVIATIONS

EEC	European Economic Community
GATT	General Agreement on Trade and Tariff
ISO	Insurance Services Office, Inc.
MGIC	Mortgage Guaranty Insurance Corporation
RAA	Reinsurance Association of America
RIMS	Risk and Insurance Management Society

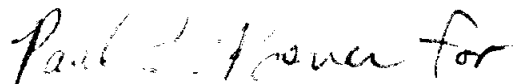
foreign tax laws that affect reinsurers covering U.S. risks, examined studies of the effects of the 1986 act on American reinsurers, and collected data on the U.S. reinsurance market, such as premiums paid to U.S. and foreign reinsurers since 1960. We also spoke with officials from the Department of the Treasury and the Department of Commerce, and with representatives of both reinsurance consumers and industry trade associations. We did not test the adequacy or accuracy of the data obtained from various sources, nor did we verify the comments of the various officials we interviewed.

Our work was done from November 1988 through June 1989 and in accordance with generally accepted government auditing standards. Appendix III discusses our objective, scope, and methodology in greater detail.

As agreed with your office, we did not obtain formal comments on this briefing report. We are sending copies of this report to other interested parties and will make copies available to others upon request.

Major contributors to this report are listed in appendix IV. If you have any questions regarding this material, please call me on 275-6407.

Sincerely yours,



Jennie S. Stathis  
Director, Tax Policy and  
Administration Issues



Representatives of the property/casualty insurance industry have expressed concern that the comprehensive income tax changes in 1986, especially those that pertain specifically to property/casualty insurers, have significantly increased the industry's tax liability. Moreover, American reinsurance representatives say that the increased tax burden has affected their ability to compete in the American market because some foreign reinsurers are not subject to the same tax treatment as their U.S. counterparts. To mitigate disparities that the act has allegedly caused, the Reinsurance Association of America (RAA) has developed a proposal that would (1) increase the excise tax on reinsurance premiums paid to foreign reinsurers from 1 cent to 4 cents and (2) eliminate excise tax treaty waivers. RAA maintains that such a change would eliminate tax preferences for foreign competitors and restore the competitive balance that existed before the act.

#### RESULTS IN BRIEF

Available data are limited and insufficient for supporting a conclusion regarding whether the competitiveness of U.S. reinsurers in the domestic market has been affected positively or negatively by the provisions of the Tax Reform Act of 1986. Although the foreign share of the U.S. reinsurance market has grown since tax reform--from 26.1 percent in 1986 to 32.6 percent in 1987 to a projected 38.6 percent in 1988--the foreign industry's share was also relatively high during the 1960s. During that period, foreign reinsurers garnered, on average, about 37.4 percent of U.S. reinsurance premiums.

#### ISSUES FOR CONSIDERATION

Although insufficient data preclude us from drawing conclusions about the relationship between tax reform and changes in the reinsurance industry's market share, we identified several issues that should be considered in deliberating changes in the current excise tax policy. These include the following:

- What other factors besides the excise tax (such as taxes in foreign countries) influence a reinsurer's relative tax position in the U.S. market?

Although the Tax Reform Act of 1986 might have increased the tax burden on American reinsurers, reinsurers

