HOUSE OF REPRESENTATIVES STAFF ANALYSIS

BILL #: HM 617 Discriminatory Taxes/Reinsurance
SPONSOR(S): Brandes and others
TIED BILLS: **IDEN./SIM. BILLS:** SM 484

REFERENCE	ACTION	ANALYST	STAFF DIRECTOR or BUDGET/POLICY CHIEF
1) Federal Affairs Subcommittee	9 Y, 2 N	Cyphers	Cyphers
2) Economic Affairs Committee			

SUMMARY ANALYSIS

Between 2000 and 2009, 76 percent of all insured losses worldwide happened in the United States. In 2005, the United States accounted for over 90 percent of worldwide insured losses. A significant amount of insured losses over the last two decades has occurred in Florida. In 1992 alone, Hurricane Andrew caused over $15 billion in insured losses. By having access to affordable reinsurance, the direct insurers that cover Florida are able to provide more insurance access to retail level customers because more capital is available to cover the enormous risks in insuring Florida for windstorm-related losses.

Recently, attempts by both Congress and the President of the United States have been made to diminish the tax deduction claimed by domestic subsidiaries of insurance companies on reinsurance premiums paid to their foreign affiliates. It is argued that such tax increases will result in less access to, and higher costs for, property and casualty insurance in Florida. This memorial urges Congress to oppose any effort to impose new taxes that would limit the use of reinsurance provided by companies located outside the United States.

The House Memorial does not amend, create, or repeal any provisions of the Florida Statutes.

The House Memorial has no fiscal impact on state or local government.

FULL ANALYSIS

I. SUBSTANTIVE ANALYSIS

A. EFFECT OF PROPOSED CHANGES:

Background

The amount of coverage an insurer can offer is generally constrained by the amount of capital it possesses or to which it has access. When insurance companies, especially those involved in property and casualty insurance, are limited in their access to capital, their ability to write policies to new customers is diminished. One substitute for capital in these cases is reinsurance. Insurers can cede portions of customer premiums to reinsurers in exchange for agreements to pay a portion of insured losses by the insurer.[1]

Insurers who pass on parts of the risk they have taken to a second insurer for the purpose of reinsurance are engaging in outward reinsurance. The insurer who passes a risk to reinsurance is called the “cedent”, and the company granting the reinsurance is the “cessionaire”. The part of the risk that passes from the direct insurer to the reinsurer is the “cession”. Reinsurers also break down large risks into manageable portions through onward reinsurance. This is called “retrocession”. Again, this is done to spread large risks in order to avoid exposure to massive financial burdens from singular events like hurricanes or earthquakes. The reinsurer in this instance is the “retrocessionaire” and the person seeking to dilute their reinsurance risk is the retrocedent.[2]

Risk in the United States and Florida

Florida regularly faces enormous risks from events like tropical storms and hurricanes. While risks to direct insurers’ capital and ability to raise capital over the last two decades has increased due to increased construction to support the growth in population in Florida, the amount of access to all property and casualty insurance has diminished, leaving the taxpayers of Florida to manage a growing amount of risk through Citizens Property Insurance Corporation and the CAT Fund.

Reinsurance and retrocession are a vital part of risk management in Florida’s property and casualty insurance market. Reinsurance enables a direct insurer or reinsurer to take on insurance risks that go beyond their own financial strength, allowing them to provide more access to insurance for their customers. This is important for hurricane-prone states like Florida where single storm events can account for billions of dollars in insured losses. In 1992 alone, Hurricane Andrew caused over $15 billion in insured losses. By having access to affordable reinsurance, the direct insurers that cover Florida are able to provide more insurance access to retail level customers because more capital is available to cover the risks in insuring Florida for windstorm-related losses.

Foreign Reinsurers

Between 2000 and 2009, 76 percent of all insured losses worldwide happened in the United States. In 2005, the United States accounted for over 90 percent of worldwide insured losses. To mitigate that amount of exposure, multi-regional (worldwide) diversification of risk is used to protect against unsustainable insurance losses. Multi-regional diversification of high-risk potential can be managed by retrocessionaires and reinsurers to provide much more predictability and stability to insured losses. This predictability, in turn, allows them to provide more risk coverage to their cedents and retrocedents.[3]

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[1] Reinsurance: Principles and State of the Art, 2nd Edition, Edited by Andreas Schwepcke; 2004.
[2] *Id.*
[3] The Brattle Group, The Impact on the U.S. Insurance Market of H.R. 3424 on Offshore Affiliate Reinsurance: An Updated Economic Analysis, July 8, 2010.

The United States' heavily concentrated risk in relation to the rest of the world makes the purchase of foreign reinsurance, especially for risk in Florida and California, imperative. Because of this risk, nearly all of the catastrophic risk is Florida is carried by foreign reinsurers. Foreign affiliate reinsurers are reinsurers with subsidiary companies within the United States which cede premiums to the offshore company for the purpose of purchasing reinsurance.

Because of the wider diversification of risk and/or the more amendable tax climate of their home countries, foreign-affiliate reinsurers have become essential to providing access to affordable property and casualty insurance there is in Florida. In July, 2010, Commissioner Kevin McCarty described foreign insurance in this way: "Florida, more than any other state, relies on the international insurance markets to manage its property catastrophic risk. The ability to diversify catastrophic risk across the globe allows international insurers and reinsurers to provide more capacity at a lower price than otherwise would be possible."[4]

Current Situation

Currently, an offshore reinsurer that derives income abroad from reinsuring risks that originate in the United States is generally not subject to U.S. federal income tax. Bermuda reinsurers, however, pay a one percent U.S. federal excise tax on the full amount of the ceded premiums.[5] U.S. insurers can deduct the gross premium ceded from its U.S. federal income tax return, but it must treat the ceding commission as taxable income. Moreover, the U.S. insurer foregoes the deduction for losses it would have been able to take had it not ceded that risk to the reinsurer.[6] Over time, the deduction for the ceded premium tends to be fully offset because, with actuarially fair insurance, expected losses plus underwriting expenses are equal to premiums plus investment income.

On July 30, 2009, Representative Neal of Massachusetts introduced HR 3424.[7] The legislation limits the tax deductibility of premiums that foreign-owned U.S. subsidiary insurers cede to affiliate reinsurers offshore. Specifically, the legislation creates a benchmark, known as the "industry fraction," which represents the average industry level of nonaffiliated reinsurance by line of business. When the share of premiums ceded to an offshore reinsurer (non-affiliate as well as affiliate) by a U.S. subsidiary exceeds this industry fraction, the "excess" affiliate reinsurance is taxable as corporate income.[8]

Recently, President Obama's budget proposal for 2011 sought to generate revenue by denying U.S.-based insurance companies a deduction for certain reinsurance premiums ceded to it by offshore parents. Under the proposal, a U.S. insurance company would not be allowed a deduction to the extent that the foreign reinsurers or their parent companies are not subject to U.S. income tax with respect to premiums received, and the amount of reinsurance premiums, or net of ceding commissions, paid to foreign reinsurers exceeds 50 percent of the total direct insurance premiums received by the U.S. insurance company and its U.S. affiliates.[9] So far, the proposal has met with significant resistance from the Florida Congressional delegation.

Effects of Proposed Changes

This memorial urges Congress to oppose any effort to impose new taxes that would limit the use of reinsurance provided by companies located outside the United States. Copies of the memorial are to

[4] Letter from Commissioner Kevin McCarty to Congressman Gus Bilirakis on July 29, 2010.
[5] http://www.irs.gov/businesses/small/article/0,,id=186963,00.html#CH1intro
[6] *Id.*
[7] http://www.govtrack.us/congress/bill.xpd?bill=h111-3424
[8] The Brattle Group, The Impact on the U.S. Insurance Market of H.R. 3424 on Offshore Affiliate Reinsurance: An Updated Economic Analysis, July 8, 2010.
[9] http://www.businessinsurance.com/article/20100201/NEWS/100209992

be sent to the President of the United States, the President of the United States Senate, the Speaker of the United States House of Representatives, and to each member of the Florida delegation to the United States Congress.

The legislation also includes whereas clauses in order to support the memorial. The whereas clauses include:

WHEREAS, reinsurance plays a vital role in managing and spreading risk for companies in nearly all segments of the insurance business, and

WHEREAS, as a means of managing capital, all large insurers make use of "affiliated" reinsurance purchased from companies within the same group, and

WHEREAS, such affiliated reinsurance serves a valid and important risk-transfer purpose that provides significant additional primary insurance capacity, particularly in areas such as crop, windstorm, general, liability, products liability, and aircraft insurance, and

WHEREAS, insurance groups that are not based in the United States currently pay taxes on reinsurance transactions which are functionally equivalent to the taxes paid by United States-based insurance groups, and

WHEREAS, a major study from the economic research and consulting firm, The Brattle Group, concluded that policies intended to reduce the use of affiliated reinsurance by companies whose headquarters are located outside the United States would result in a 20 percent reduction in the supply of reinsurance and a significant increase in the price of primary insurance for consumers and businesses, and

WHEREAS, such taxation would significantly limit the ability of many insurers to manage their capital and, thus, undermine the international risk-management practices at the heart of international reinsurance markets, and

WHEREAS, a broad coalition of industry, consumer, and free-market groups have spoken out against discriminatory taxation of offshore affiliated reinsurance…

B. SECTION DIRECTORY:

None

II. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT

A. FISCAL IMPACT ON STATE GOVERNMENT:

1. Revenues:

   None

2. Expenditures:

   None

B. FISCAL IMPACT ON LOCAL GOVERNMENTS:

1. Revenues:

   None

2. Expenditures:

None

C. DIRECT ECONOMIC IMPACT ON PRIVATE SECTOR:

None

D. FISCAL COMMENTS:

None

III. COMMENTS

A. CONSTITUTIONAL ISSUES:

1. Applicability of Municipality/County Mandates Provision:

   Not Applicable

2. Other:

   None

B. RULE-MAKING AUTHORITY:

Not Applicable

C. DRAFTING ISSUES OR OTHER COMMENTS:

None

IV. AMENDMENTS/ COMMITTEE SUBSTITUTE CHANGES