We use cookies to improve your website experience. To learn about our use of cookies and how you can manage your cookie settings, please see our Cookie Policy. By continuing to use the website, you consent to our use of cookies.

This copy is for your personal, non-commercial use. For high-quality copies or electronic reprints for distribution to colleagues or customers, please call UK support +44 (0)20 3377 3996 / APAC support at +65 6508 2430

Printed By **Simon Price**

Innovative structures emerge to beat US offshore reinsurance tax

14 Jun 2018 | **ANALYSIS**

by Rodrigo Amaral

The Base Erosion Anti-Abuse Tax will severely punish companies that employ offshore vehicles, driving the creation of alternative structures

VERMONT IS LEADING THE CHARGE IN CREATING INNOVATIVE NEW COMPANY STRUCTURES TO AVOID FALLING FOUL OF THE US BEAT LAWS *Source: Sean Pavone/Shutterstock.com*

The tax reform implemented by US president, Donald Trump, at the end of last year has been lauded as the greatest achievement of his presidency so far. For insurance companies in the US, however, it has created an extra source of costs with the potential to derail their offshore reinsurance arrangements.

One of the provisions of the Tax Cuts and Jobs Act (TCJA) was the creation of the Base Erosion Anti-Abuse Tax (Beat), which severely punishes companies that employ offshore vehicles to reduce their tax bills. Reinsurance affiliates based in Bermuda and other international jurisdictions are among the firms to suffer the most from the charge.

Sensing an opportunity, the state of Vermont, famous for its captive-hosting capabilities, has created a new scheme, which will launch in July, that aims to offer insurers an alternative to avoid a large Beat bill without relinquishing the benefits delivered by offshore reinsurance companies, such as more efficient management of capital reserves.

Meanwhile, some insurers have taken the bull by the horns and implemented creative solutions to beat the new tax, while maintaining the access to global reinsurance markets that is crucial for their business strategies, legal experts say.

Beat has hit offshore reinsurance affiliates right on the nose by imposing a new charge on transactions made by US-based companies with related parties that have the goal of reducing the tax base from which their US taxes are calculated.

> **"Vermont did everything it could to make the credit reinsurance question easy for states to answer, but we will have to see a few operations come through to really know how it will look like"**
>
> *J Zaw Win*
>
> *DRM*

In the case of insurers, it implies a minimum tax on income adjusted for base erosion payments to their offshore affiliated reinsurers. The minimum tax rate is 5% this year, climbing to 10% between 2019 and 2025, and 12.5% thereafter – all of which is on top of the 1% excise tax that is charged on premiums paid to overseas reinsurers.

The new tax applies to corporate groups that have average gross receipts of more than $500m in the previous three tax years and for which base erosion tax benefits amount to at least 3% of the group's total US tax deductions.

The wording of the law makes it likely insurers operating in the US that transfer significant volumes of premiums to their reinsurance affiliates in Bermuda and other offshore jurisdictions are set for a hefty bill. Not surprisingly, a number of firms have announced in the first half of 2018 they are restructuring in the face the new regulatory environment; these include Arch Capital and Assurant Group.

The implementation of Beat has given the chief financial officers of many US insurers a headache but it has also found supporters in the industry. For example, the Coalition for American Insurance, a pressure group that counts the likes of CNA Financial and Berkshire Hathaway among its members, has argued it removes a distortion that has given foreign companies a significant advantage over their local peers.

New structures

Looking at a new potential demand for Beat-free vehicles, earlier this year Vermont approved a new regime that intends to provide US insurers with an onshore vehicle to enable them to replicate the features that have made Bermuda-based affiliates so attractive.

The Vermont structure is based on the creation of a new kind of company licence called Affiliated Reinsurance Company (Arc). It is viewed as a hybrid between a traditional reinsurance company and a captive.

"From a regulatory point of view, we can expect them to be more heavily regulated than captives, but less than traditional insurers," J Zaw Win, an insurance expert at the DRM law office in Burlington, Vermont, says. "Captive regulators in Vermont have a reputation of being very flexible and pragmatic. You would expect that to carry over to Arcs."

The most important feature of the new vehicle is it will have much greater freedom to define investment strategies than traditional insurers do, as the latter have to follow the much stricter guidelines imposed by the National Association of Insurance Commissioners (NAIC). These guidelines limit investment options and require diversification and liquidity, which critics say do not keep up with changes in the investment environment.

> **"It is possible to structure an alternative capital vehicle with some sponsored ownership but with sufficient outside investment and control, so the vehicle can assume risks from a sponsor free of Beat"**
>
> *Mike Seaton*
>
> *Clifford Chance*

"Rather than telling companies how they should invest their funds, we will ask them to present us a plan that addresses diversification and liquidity and, if we are OK with the plan, we will approve it," David Provost, the deputy commissioner of captive insurance at the Vermont government, says.

States where the ceding company is based, however, may want to have a say on the robustness of the Arc's investment plans.

"The statute also refers to making sure that companies get credit for reinsurance from their ceding insurance regulator," Provost adds. "So it is entirely possible the ceding company's regulator will have some input on its investment plan as well or at least will want to understand it before it gives credit to reinsurance."

Win says: "Vermont did everything it could to make the credit reinsurance question easy for states to answer, but we will have to see a few operations come through to really know how it will look like."

Vermont's insurance department intends to grant licences after a period of 30 to 60 days following application. Arcs must have a local place of business, but their sponsors can choose to either open offices or employ a local manager. They will pay a maximum premium tax of $200,000 and will be asked to keep minimum capital reserves of $5m, although it is expected vehicles will hold much higher.

In addition to the $5m floor, they will have to meet risk-based capital requirements that are acceptable both to Vermont and the ceding state regulator.

Different solutions

Vermont's new scheme may well become a solution for companies trying to keep the business advantages of offshore reinsurance without paying a high tax bill. But it is still too early to tell whether the new scheme will gain the favour of the market.

In fact, the search for new anti-Beat alternatives has taken several different shapes and some of the solutions adopted by insurers are good news for offshore jurisdictions such as Bermuda.

"One option to deal with Beat is to terminate the quota-share reinsurance arrangements some US insurers have with offshore affiliates and some have done that," Gary Boss, a partner at Clifford Chance in New York, says. "But many of our clients are looking at other ways to continue reinsurance flows outside the US and which are consistent with the Beat requirements."

For instance, US law already allows US-based insurers to create reinsurers that are based offshore for regulatory reasons, but are treated as US companies for tax purposes (so-called section 953(d) vehicles), which enables them to dodge Beat.

"Section 953(d) vehicles help to preserve some of the non-tax benefits of reinsurance affiliates based in Bermuda, such as a more flexible regulatory regime and broader investment possibilities," Mike Seaton, a partner at Clifford Chance says.

According to Seaton, several clients have shown interest in this kind of arrangement, but not all companies can benefit from it.

Another possibility is to spread out the ownership of the affiliated reinsurer in such a way that it can fall below the requirements of Beat legislation. "It is possible to structure an alternative capital vehicle with some sponsored ownership but with sufficient outside investment and control, so the vehicle can assume risks from a sponsor free of Beat," Seaton says.

"The exact line demarcating control is not entirely clear yet as the test in the Beat statute is very fact-sensitive, but there are practical ways to disconnect companies from their outside sponsors to minimise the risk Beat will apply."

Some companies have been able to avoid the charges by ceding to offshore affiliates a volume of premiums that falls below the Beat requirements, Seaton says. As Beat works to some extent as a minimum threshold tax, some insurers are implementing strategies where they mix a degree of risk transfer to an offshore vehicle and another amount to a section 953(b) vehicle with this goal.

In the way Beat is drafted now, it seems to apply on a gross basis to reinsurance cessions. This means Beat is far more punitive to reinsurance transactions than to most other kinds of transactions subject to Beat. Some people have questioned, however, whether legislators really intended the law be applied to reinsurance transactions so harshly. It is possible future guidance will soften the impact of Beat on reinsurance transactions, the Clifford Chance lawyers say.

For the time being, the Beat threat has not been enough to turn US-based insurers away from offshore reinsurance arrangements with affiliated units. "In the past six months, we have witnessed a fairly marked increase in transactional work involving offshore reinsurance among our clients," Boss says.