AIG
175 Water Street, 28th FL
New York, NY 10038
www.aig.com

Angela Bekker
VP, Head of Global Tax
T +1 212 770 6350
M +1 347 712 2712
angela.bekker@aig.com

February 19, 2019

via https://www.regulations.gov/

Secretary of the Treasury
c/o Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: CC:PA:LPD:PR (REG-104259-18)
Proposed Regulations on Base Erosion and Anti-Abuse Tax

Dear Mr. Secretary:

We file these comments on the Notice of Proposed Rulemaking (REG-104259-18) ("proposed regulations") published in the Federal Register on December 21, 2018, which provides guidance on the new base erosion and anti-abuse tax ("BEAT") (Section 59A).[1] These comments address the treatment of reinsurance, an area for which the background to the proposed regulations (the "Preamble") requested comments. This letter specifically addresses the appropriate treatment of ceding commissions paid by a domestic reinsurance company to a foreign related insurance company in exchange for such reinsurance.

We recommend that final regulations under Section 59A exclude ceding commissions paid to a foreign affiliate in exchange for the reinsurance of foreign risks by a U.S. reinsurer from the definition of a "base erosion payment" in Prop. Treas. Reg. §§ 59A-2(e)(3)(ii) and -3(b)(3) in a similar manner as Section 988 losses or TLAC securities. In the alternative, Treasury should permit U.S. reinsurers to look-through licensed insurance affiliates in foreign jurisdictions to determine which portion of ceding commissions paid to such affiliates should be excluded from the definition of a base erosion payment.

We were also a signatory on the letter dated February 15, 2019 submitted by 41 insurance companies arguing for the exclusion of certain claims payments from the numerator of the base erosion percentage fraction. Our recommendations on ceding commissions are based on the same policy arguments that would exclude claims payments made to a foreign affiliate on

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986 (the "Code"), as amended.

reinsurance of foreign risks to a U.S. reinsurer – i.e., to recognize that they are not a base erosion payment and considering them as such would discourage investment in the U.S. reinsurance industry.

Proposed Regulations

Proposed Regulations 1.59A-2(b) and -2(e) describe how corporate taxpayers are subject to BEAT to the extent they meet a certain gross receipts threshold and satisfy the "base erosion percentage test." The base erosion percentage test is generally calculated as the total of taxpayer's base erosion payments (the numerator) divided by the taxpayer's total deductions (the denominator). The denominator excludes deductions for net operating losses, section 250, and certain dividends received deductions. Also excluded from the denominator are the payments to foreign affiliates that were excluded from the numerator because of an available exception. Taxpayers that do not have a base erosion percentage of at least 3% (2% for groups containing a substantial securities dealer) are not subject to BEAT.

Proposed Regulation 1.59A-3(b)(3) lists the specific exceptions available for deductible payments. These include qualified derivatives and certain service fees as reflected in the statutory language. The regulations permit service fee contracts with foreign affiliates to be disaggregated pursuant to the taxpayer's books and records to exclude that potion of the fees that are entitled to the services cost method from the definition of a base erosion payment. Prop. Treas. Reg. § 1.59A-3(b)(3)(i)(C). They also include two new exceptions placed under Treasury's rule-making authority: Section 988 foreign exchange losses and amounts paid or accrued on the amount of TLAC securities required by banking regulators. The exclusion for Section 988 losses arose because ". . . these losses do not present the same base erosion concerns as other types of losses that arise in connection with payments to a foreign related party."[2] The exclusion for TLAC securities was because TLAC's were ". . . part of a global system to address bank solvency . . . ." and that they were limited by regulation.[3]

As the Preamble states, the Proposed Regulations do not contain any specific rules on the treatment of a domestic reinsurer making payments to a foreign reinsured. The Preamble does ask for comments on the treatment of reinsurance payments generally.[4]

American International Group, Inc. submits its comments in relation to these questions and how they apply to U.S. reinsurance of foreign risks.

Payments by U.S. Reinsurers to Reinsureds are Not Base Erosion Payments

A reinsurance contract involves payments to and from both the reinsurer and the reinsured. The most substantial payments are (i) premiums; (ii) ceding commissions; and (iii) claims payments.[5]

---

[2] Preamble at 36. References to page numbers in the Preamble are to the pagination of the Proposed Regulations issued December 13, 2018 prior to their publication in the Federal Register.

[3] Preamble at 37-38.

[4] Preamble at 60-62.

[5] An insurance company that purchases reinsurance from another company is often called the "cedent" (i.e., the one that cedes risk) or "reinsured."

Premiums are the consideration paid to the reinsurer for the assumption of risks on the original contracts issued by the reinsured. In quota share reinsurance, the premium is quantified directly based on the premiums received by the insurer from its customers. In substance the reinsurer assumes the risks and economics of its portion of the quota share. A ceding commission is a payment from the reinsurer to the reinsured to compensate the reinsured for its costs of acquiring the reinsured contracts and a small profit component.[6] Depending on the line of business, a substantial portion of that cost would be commissions paid to third parties (e.g., brokers or agents) for placing the business with the insurer.

Ceding commissions and claims payments back to the reinsured company would typically constitute around 80% or more of the amount of premiums received by the reinsurer - resulting in a net increase in U.S. taxable income from the transaction even before the U.S. taxable income from investing the premiums.

The pricing of all elements of a reinsurance contracts (premiums and ceding commissions) are required to be calculated at arms' length and are reviewed and approved by regulators both in the U.S. and in the ceding company's jurisdiction. Unlike other taxpayers, regulated insurers are not free to restructure their operations or change their contracts to effectively "net out" base erosion payments.

Under most standard quota share reinsurance contracts, the ceding commission and premiums received are separately stated, but not separately paid. The only reason for the separate statement is the insurance regulatory requirement in statutory financials that all the components of a risk transfer be separately stated. This then enters the Code through the general requirement to use statutory accounts as the basis of taxable income for nonlife insurance companies.[7] The distinction had little practical impact on the income tax prior to section 59A and results in treatment contrary to the economic substance of the transaction.[8]

U.S. Reinsurers Should Be Permitted to Look Through Their Foreign Affiliates

If ceding commissions are not excluded - in their entirety - from the definition of a base erosion payment, we recommend that U.S. taxpayers be permitted to look-through and disaggregate ceding commissions and similar payments related to the reinsurance of foreign risks that are required by non-US law to be paid to an affiliate. This would permit an exclusion from the definition of base erosion payments the portion of such payments that compensates the foreign affiliate for either (i) third-party expenses incurred in sourcing the business or (ii) for cost method services included in the expense base. A rule permitting such an exclusion can be narrowly crafted and we would welcome the opportunity to work with Treasury to ensure that abusive transactions are not allowed.

---

[6] *See, e.g., Trans City Life Ins. Co. v. Commissioner*, 106 T.C. 274, 280 (1996); Rev. Rul. 79-138, 1979-1 C.B. 359; OECD, 2010 Report on the Attribution of Profits to Permanent Establishments, Part IV, para. 20; Dep't of Treasury, Internal Revenue Service, Market Segment Specialization Program Audit Technique Guides, Foreign Insurance Excise Tax, Ch. 10 (2008)

[7] *See* Code § 832(b)(1)(A); *see also See also Sears, Roebuck & Co. v. Commissioner*, 972 F.2d 858, 866 (7th Cir. 1992).

[8] *But see* Rev. Rul. 79-138 (ignoring the netting of ceding commissions because premiums were measured gross for purposes of the federal excise tax on reinsurance premiums under section 4371).

In substance, a ceding commission has three components: (i) reimbursement of third-party expenses incurred by the reinsured; (ii) payment for services performed by the reinsured's own employees; and (iii) a small profit component. Some portion of the services performed by the reinsured's own employees would be expected to qualify for the exception for services cost method payments under Prop. Treas. Reg. § 1.59A-3(b)(3)(i). The reimbursement of third-party expenses could properly be considered a payment to a third-party under agency or similar common law principles.[9] Payments to third parties are not base erosion payments.

In the case of reinsurance, "insurance or reinsurance" services are not performed on behalf of the payor (the reinsurer), they are performed for the third-party customers who purchase the insurance. A ceding commission is therefore not properly considered a payment for insurance or reinsurance services, but merely an expense reimbursement. Under a quota share, the reinsurer is paying for the expenses associated with its portion ("quota") of the business written. Unfortunately, laws restricting insurance activities and statutory accounting principles prevent the reinsurer from directly booking these expenses – instead a ceding commission is required.

Under the insurance regulatory rules of most countries, non-resident insurance companies are prevented by law from making payments to insured customers or licensed insurance intermediaries like brokers and agents.[10] Such payments would constitute an unauthorized insurance business and could result in criminal sanction.[11] Therefore, unlike taxpayers outside the insurance industry, reinsurers are not free to restructure their contracts or operations to eliminate inadvertent base erosion payments.

Tax law is replete with provisions that allow a taxpayer to ignore a form they are only required to use because of foreign law and treat a transaction according to its substance[12] or to simply permit an exception to a normally applicable tax law in such a situation.[13] Within the proposed regulations, Treasury recognized the need for a similar exception for TLAC securities required by banking regulation.

While the need to look-through the licensed foreign insurance affiliate could be alleviated by operating through a branch structure, such structures are either prohibited or strongly disfavored by insurance regulators worldwide.[14] Just as a bank is not required to issue TLAC's to third parties in order to avoid treatment as a base erosion payment, insurance groups should not be required

---

[9] The Preamble (at 19-20). Common law and other doctrines that would ignore the intermediary in the payment of a third-party expense would include: (i) agency considerations, *see, e.g.,* PLR 9417028 (ignoring the auto dealer in a warranty payment); *Horace Mill and Ruby A. Mill v. Commissioner*, 5 T.C. 691 (1945) (handing over slot machine proceeds to the gambling hall); (ii) the reimbursement doctrine, *see, e.g., Beech Trucking Co. v. Commissioner*, 118 T.C. 428 (2002) (discussing section 274); and (iii) conduit theory, *see, e.g.,* Code § 7701(l) and associated regulations.

[10] *See, e.g.,* Law No. 105 of 1995 (Insurance Business Act) (Japan) *available at* http://www.japaneselawtranslation.go.jp/law/detail/?ft=2&re=01&dn=1&yo=%E4%BF%9D%E9%99%BA%E6%A5%AD%E6%B3%95&ia=03&ph=&x=14&y=7&ky=&page=1

[11] *Id.* at Art. 315 (up to three years in prison).

[12] *See, e.g.,* Rev. Rul. 84-142.

[13] *See, e.g.,* Code § 964(b) (blocked income cannot be Subpart F).

[14] This has been a long-term trend in global insurance regulation. Even studies done 20 years ago showed that countries were moving away from permitting branch structures. *See* OECD, "Insurance Regulation and Supervision in OECD Countries, Asian Economies and CEEC and NIS Countries," § 2.2.9 (Feb. 1999).

to utilize uneconomic branch structures in order to alleviate unnecessary and uneconomic base erosion payments.

We appreciate the opportunity to provide these comments on the Proposed Regulations.

Respectfully submitted,

Angela Bekker

Angela Bekker

Vice President, Head of Global Tax

American International Group, Inc.