# KPMG report: Questions for insurers and reinsurers raised by proposed border adjustment tax

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It is not clear whether tax reform will be enacted in the short term or, if it is, what the details would be. However, one of the proposals receiving significant attention is the House Republican "blueprint."[1] The blueprint proposes (among other things) a "destination-based cash flow tax with border adjustment" ("DBCFT").

The blueprint is a high level document. As a result, there are few technical details available regarding its proposals in general, and fewer regarding how its version of the DBCFT would apply to financial transactions. One concern is the potential treatment of insurance and, more specifically, cross-border reinsurance.

Since risk pooling and risk spreading across borders are essential to well-functioning insurance markets, the potential impact of any tax reform proposal on risk pooling and risk spreading is important to consider, especially since factors other than tax, such as regulatory environment, already impose powerful influences over the location of reinsurance pools. This report briefly examines how a DBCFT might apply to insurance and reinsurance transactions through simple examples. This report is not intended to be an endorsement of any particular treatment of insurance or reinsurance under a DBCFT, nor is it intended to take a position on whether a DBCFT should be adopted.

## Summary of GOP "blueprint"

Some of the most significant changes to the current tax system proposed in the blueprint are:

- Reduction of the corporate tax rate to a flat rate of 20%.
- Full and immediate write-off (or "expensing") of the cost of investments.
- Elimination of a current deduction for net interest expense. Taxpayers would be allowed to deduct interest expense against any interest income. Any net interest expense could be carried forward indefinitely and allowed as a deduction against net interest income in future years.
- There would be no carryback of net operating losses ("NOLs"), but NOLs could be carried forward indefinitely, increased by an interest factor that compensates for inflation and a real return on capital to maintain the value of amounts that are carried forward. A deduction for NOLs carried forward would be limited in any year to 90% of the net taxable amount for such year determined without regard to the carryforward.
- Tax jurisdiction would follow the location of consumption rather than the location of production. The blueprint would achieve this by providing for border adjustments—exempting exports from tax and taxing imports.

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[1] A Better Way—Our Vision for a Confident America, (June 24, 2016) (a document referred to as the "blueprint" published by the House of Representatives Republican Tax Reform Task Force).

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- The existing worldwide tax system would be replaced with a territorial tax system.

The DBCFT proposed in the blueprint bears some resemblance to a value-added tax ("VAT"), but, as a technical matter, differs from a traditional VAT in several important respects, including by providing a deduction for employee compensation.

The stated purpose of the DBCFT in the blueprint is to:

- Encourage growth and competitiveness of all job creators.
- Focus on investment in and for the United States.
- End the self-imposed unilateral penalty for exports and subsidy for imports that are fundamental flaws in the current U.S. tax system.
- Allow U.S. companies to repatriate earnings to invest in the U.S. without tax penalty.
- Simplify international tax rules, and reduce compliance burdens and the potential for controversy.

## Application of the blueprint to the insurance industry

The blueprint states that one goal of the DBCFT is to encourage exports, which (if achieved) could create jobs in the U.S.

This statement is not very useful in understanding how the DBCFT might apply in the context of insurance: insurance and reinsurance transactions are not naturally characterized as imports or exports, as a transaction in tangible goods might be. For example, insurance transactions entail a number of cash flows between the parties over time, not a single payment in exchange for a good or service. Those cash flows may include:

- Premiums
- Ceding commissions
- Claims payments
- Funds withheld and Mod-co settlements
- Interest on funds withheld
- Administrative expenses
- Experience refunds

The proposal includes immediate expensing of investments instead of depreciation or other methods of cost recovery, and an elimination of other corporate deductions, but provides no detail about how, for example, insurance reserves and investment income would be treated. Moreover, it does not provide any indication of how the DBCFT might apply to various cash flows that arise from insurance and reinsurance. By necessity the analysis below makes assumptions and considers several possible treatments to compare their results.

One particularly important question is how exports and imports might be determined in the context of insurance. Some argue that when a U.S. direct writer reinsures risk to a foreign reinsurance provider, the transaction could be viewed as an import of insurance services. In contrast, some argue that that risk could be considered to be like a good that is exported in such a transaction. As shown in the examples below,

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this debate could have significant consequences that flow from denying the deduction for costs of imports or excluding receipts from exports. One approach that avoids the need to characterize the transaction would disregard all cross-border cash flows relating to reinsurance,[2] but this would have a result similar to treating insurance as a service rather than treating risk as a good.

Adding to the difficulty of assessing the potential impact of a DBCFT on the insurance industry is that, according to many economists, a border adjustment would result in a strengthening of the dollar against foreign currencies, making U.S. goods more expensive and offsetting the stimulative effect of a border adjustment tax on exports. Because there is no consensus on how much currency exchange rates would change in response to the tax, and due also to the fact that most large cross-border reinsurance transactions are denominated in dollars, this analysis does not attempt to take into account currency exchange rates.

This report makes a number of simplifying assumptions to highlight some basic issues that arise in applying a DBCFT to cross-border reinsurance, and does not discuss certain considerations, such as time value of money, that could ameliorate or exacerbate results shown in the examples. This should not be taken as an endorsement of these assumptions or as a view that they are necessary or inevitable.

The following examples suggest how a DBCFT might, depending on the rules adopted by taxwriters, materially impact the cost of cross-border reinsurance, regardless of whether the relevant characteristic for determining export or import is transfer of risk or performance of services.

## Examples

In face of this uncertainty, the following seeks to illustrate various ways that a border adjustment tax (if enacted) might be applied to insurance and reinsurance transactions through a set of examples. Other than Example 1, each example presents alternative ways a DBCFT might apply to reinsurance. In each reinsurance example, 100% of the risk is transferred.

The examples assume that all U.S. risks originate with U.S. direct writers, and all non-U.S. risks originate with non-U.S. direct writers. However, more detail than is provided by the blueprint would be needed to answer the question of whether the “destination” of insurance and reinsurance is based on the location of the risk, the location of the insured, the location of the ceding company, or something else.

Under current law, premium, ceding commissions and reductions in reserves are taxable gross income, and expenses, losses paid, and reserve increases are deductible expenses. The examples below generally assume no change in these rules other than what is specified. In addition, the examples ignore the differences between book and tax such as reserve discounting and expensing of costs. They do not include the effect of federal excise tax on insurance premiums paid to a foreign reinsurer nor

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[2] This discussion does not address direct writing of insurance across borders because this raises other issues not addressed here. The following examples assume that all U.S. risk is written directly by a U.S. taxpayer and all non-U.S. risk is written by a non-U.S. taxpayer.

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do they consider investment income. The examples first show insurance transactions that are completed within a single taxable year and later contrast examples of transactions that span two years.

As described in the blueprint, a 20% corporate tax rate is used. For simplicity's sake, the examples do not take into account any effect the DBCFT would have on the behavior of insureds. They also assume that any potential tax treatment of the insurance provider would be the same regardless of whether the insured is an individual or a business.

The following chart summarizes the results of the base-line examples, which assume a $1,000,000 direct written premium, a 30% expense ratio, a 60% loss ratio, and net reinsurance premium (if any) of $700,000, and assume that all losses are paid in the first year. Unless otherwise indicated, the numbers represent the income and tax liability of the U.S. taxpayer, as applicable.

| **Example** | **Result** | **Economic Income** | **Taxable Income** | **Tax Liability** |
|---|---|---|---|---|
| Example 1: U.S. direct writer, no reinsurance. This result also applies to a domestic reinsurer described in Example 2, below. | Similar to current law | 100,000 | 100,000 | 20,000 |
| Example 2: U.S. direct writer cedes to U.S. reinsurer. No cross-border transaction. See Example 1 for tax impact on domestic reinsurer. | Similar to current law | 0 | 0 | 0 |
| Example 3A: U.S. direct writer cedes to non-U.S. reinsurer. Import of service: disallowance of payments (net ceded premium) made. | No deduction for net ceded premium | 0 | 700,000 | 140,000 |
| Example 3B: U.S. direct writer cedes to non-U.S. reinsurer. Export of risk: exclusion of payments (ceded loss recovery) received. | No inclusion of ceded loss recovery | 0 | (600,000) | 0 |
| Example 4: U.S. direct writer cedes to non-U.S. reinsurer—disregard of all cross-border cash flows. | No deduction for net ceded premium, no inclusion of ceded loss recovery | 0 | 100,000 | 20,000 |

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| | | | | |
|---|---|---|---|---|
| Example 5A: U.S. reinsurer is ceded non-U.S. risk from Non-U.S. direct writer. Export of service: exclusion of payments (net ceded premium) received. | No inclusion of net ceded premium | 100,000 | (600,000) | 0 |
| Example 5B: U.S. reinsurer is ceded non-U.S. risk from non-U.S. direct writer. Import of risk: disallowance of payments (ceded losses) made. | No deduction for ceded losses paid | 100,000 | 700,000 | 140,000 |
| Example 6: U.S. reinsurer is ceded non-U.S. risk from non-U.S. direct writer. Disregard of all cross-border payments | No inclusion of net ceded premium, no deduction for losses paid | 100,000 | 0 | 0 |

Examples 7-10 show the possible effects under each scenario when losses are paid in a later year.

**Example 1: U.S. direct writer of U.S. risk with no reinsurance**

The following example assumes $1,000,000 of premium, which results in $100,000 of underwriting income.

| **Example 1** | | | |
|---|---|---|---|
| | **Economic** | **Statutory** | **Tax** |
| | | | |
| Premium | 1,000,000 | 1,000,000 | 1,000,000 |
| Expenses | (300,000) | (300,000) | (300,000) |
| Initial Loss Reserve | (600,000) | (600,000) | (600,000) |
| | | | |
| Loss Paid | (600,000) | (600,000) | (600,000) |
| Reserve Adjustment for losses paid | 600,000 | 600,000 | 600,000 |
| | | | |
| Income (Loss) | 100,000 | 100,000 | 100,000 |
| | | | |
| Tax Liability | | | 20,000 |

The result in this example is the same as under current law but with a tax rate reduced from 35% to 20%.

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**Example 2: U.S. direct writer cedes 100% of U.S. risk to U.S. reinsurer—No cross-border transaction**

This example also assumes a $1,000,000 premium, but the entire risk is reinsured with a domestic reinsurer.

| **Example 2** | **Direct Writer** | | | **Domestic Reinsurer** | | |
|---|---|---|---|---|---|---|
| | **Economic** | **Statutory** | **Tax** | **Economic** | **Statutory** | **Tax** |
| | | | | | | |
| Premium | 1,000,000 | 1,000,000 | 1,000,000 | | | |
| Expenses | (300,000) | (300,000) | (300,000) | | | |
| Initial Loss Reserve | (600,000) | (600,000) | (600,000) | | | |
| | | | | | | |
| (Ceded) Reinsurance Premium | (1,000,000) | (1,000,000) | (1,000,000) | 1,000,000 | 1,000,000 | 1,000,000 |
| Reserve adjustment for ceded reserves | 600,000 | 600,000 | 600,000 | (600,000) | (600,000) | (600,000) |
| Ceding Commission | 300,000 | 300,000 | 300,000 | (300,000) | (300,000) | (300,000) |
| | | | | | | |
| Loss Paid | (600,000) | (600,000) | (600,000) | (600,000) | (600,000) | (600,000) |
| Reserve Adjustment for losses paid | | | | 600,000 | 600,000 | 600,000 |
| Ceded Loss Recovery | 600,000 | 600,000 | 600,000 | | | |
| | | | | | | |
| Income (Loss) | 0 | 0 | 0 | 100,000 | 100,000 | 100,000 |
| | | | | | | |
| Tax Liability | | | 0 | | | 20,000 |

As in the prior example, the result is similar to current law. In this case the U.S. insurer has no economic income and no taxable income or loss. The U.S. reinsurer, having assumed 100% of the business and therefore $100,000 of profits, could be subject to the tax. The following examples contrast that treatment to the possibilities under the DBCFT when there is a non-U.S. reinsurer. These examples assume that the non-U.S. reinsurer is not subject to U.S. income tax.

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**Example Set 3: Outbound reinsurance: U.S. direct writer cedes 100% of U.S. risk to non-U.S. reinsurer—Asymmetrical treatment**

In these examples a U.S. direct writer cedes 100% of its U.S. risk to a non-U.S. reinsurance provider.

**Example 3A: treatment as import of services:** this examines what might result if the DBCFT treated the cross-border reinsurance transaction as an import of insurance services by the U.S direct writer. That could eliminate a deduction for the net ceded premium (i.e., the cost of the import is the ceded premium less the ceding commission). This is termed "asymmetrical" treatment to reflect that only one side of the cross-border cash flows is excluded, as compared to a "symmetrical" treatment that would disregard all cross-border cash flows.

| **Example 3A** | | | |
|---|---|---|---|
| | **Economic** | **Statutory** | **Tax** |
| | | | |
| Premium | 1,000,000 | 1,000,000 | 1,000,000 |
| Expenses | (300,000) | (300,000) | (300,000) |
| Initial Loss Reserve | (600,000) | (600,000) | (600,000) |
| | | | |
| Ceded Premium | (1,000,000) | (1,000,000) | -- |
| Reserve adjustment for ceded reserves | 600,000 | 600,000 | 600,000 |
| Ceding Commission | 300,000 | 300,000 | -- |
| | | | |
| Loss Paid | (600,000) | (600,000) | (600,000) |
| Reserve Adjustment for losses paid | | | |
| Ceded Loss Recovery | 600,000 | 600,000 | 600,000 |
| | | | |
| Income (Loss) | 0 | 0 | 700,000 |
| | | | |
| Tax Liability | | | 140,000 |

The result of disallowing a deduction for the net ceded premium (income of $700,000 and a tax of $140,000 on the transaction) is significantly different from the result under a wholly domestic reinsurance transaction ($100,000 of income and $20,000 of tax to the U.S. reinsurer), and could be seen as creating a disincentive for cross-border risk pooling and spreading.

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**Example 3B: treatment as export of risk:** this examines what might result if the DBCFT treated the cross-border reinsurance transaction as an export of risk by the U.S. direct writer. This could provide an exclusion from income of the ceded loss recovery by the U.S. insurer, but no special treatment of the net ceded premium or any other amount. Similar to Example 3A, we have described this example as "asymmetrical" because only one side of the cross-border cash flows is excluded.

| **Example 3B** | | | |
|---|---|---|---|
| | **Economic** | **Statutory** | **Tax** |
| | | | |
| Premium | 1,000,000 | 1,000,000 | 1,000,000 |
| Expenses | (300,000) | (300,000) | (300,000) |
| Initial Loss Reserve | (600,000) | (600,000) | (600,000) |
| | | | |
| Ceded Premium | (1,000,000) | (1,000,000) | (1,000,000) |
| Reserve adjustment for ceded reserves | 600,000 | 600,000 | 600,000 |
| Ceding Commission | 300,000 | 300,000 | 300,000 |
| | | | |
| Loss Paid | (600,000) | (600,000) | (600,000) |
| Reserve Adjustment for losses paid | | | |
| Ceded Loss Recovery | 600,000 | 600,000 | -- |
| | | | |
| Income (Loss) | 0 | 0 | (600,000) |
| | | | |
| Tax Liability | | | |
| | | | |
| Loss carryforward | | | (600,000) |

It also seems possible that the DBCFT would exclude the ceding commission from the U.S. insurer's income, with the result that the loss carryforward would increase to $900,000.

This approach might provide an incentive to reinsure U.S. risk offshore considering that in the purely domestic context there would be net income of $100,000 and tax of $20,000.

**Example 4: Outbound reinsurance: U.S. direct writer cedes 100% of U.S. risk to non-U.S. reinsurer—Symmetrical treatment**

This example has the same facts as the prior examples, except that it examines what might result if the DBCFT both disallowed the deduction of the net ceded premium and excluded from income the related ceding commission and ceded loss recovery. We

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have called this symmetrical treatment because it disregards all cross-border payments.

| **Example 4** | | | |
|---|---|---|---|
| | **Economic** | **Statutory** | **Tax** |
| | | | |
| Premium | 1,000,000 | 1,000,000 | 1,000,000 |
| Expenses | (300,000) | (300,000) | (300,000) |
| Initial Loss Reserve | (600,000) | (600,000) | (600,000) |
| | | | |
| Ceded Premium | (1,000,000) | (1,000,000) | -- |
| Reserve adjustment for ceded reserves | 600,000 | 600,000 | 600,000 |
| Ceding Commission | 300,000 | 300,000 | -- |
| | | | |
| Loss Paid | (600,000) | (600,000) | (600,000) |
| Reserve Adjustment for losses paid | | | |
| Ceded Loss Recovery | 600,000 | 600,000 | -- |
| | | | |
| Income (Loss) | 0 | 0 | 100,000 |
| | | | |
| Tax Liability | | | 20,000 |

This treatment could result in the U.S. direct writer being subject to tax on the underwriting income in the U.S. despite the transfer of that risk to a foreign domiciled reinsurer. Although the taxpayer has no economic income, this could be seen as a theoretically correct result if cross-border reinsurance was considered an import of services, and could eliminate the distortion potentially created by asymmetric treatment shown in Example 3A. That is, the $100,000 of underwriting income that would accrue to the reinsurer under current law could accrue and be taxed to the direct writer (the “destination” under the import concept) under the DBCFT.

On the other hand, the $20,000 tax would not be appropriate if the transaction was considered an export of risk, in which case an approach might be to allow $300,000 of net deductions.[3]

[3] One way of understanding rules that could apply under the DBCFT is by thinking of it as a subtraction method value added tax that provides a zero rating of exports—e.g., it does not tax value added by the taxpayer and allows a deduction of all expenses (including in the case of the blueprint’s version compensation and other expenses of self-created goods) as if those expenses had been previously taxed. In this example the deductions would be the $300,000 of expenses incurred by the U.S. insurer.

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**Example Set 5: Inbound reinsurance: Non-U.S. direct writer cedes 100% of non-U.S. risk to U.S. reinsurer—Asymmetrical treatment**

As in the prior examples, it is unclear whether this would represent the export of insurance services or the import of risk.

**Example 5A: treatment as export of services:** this examines what might result if the DBCFT treated the U.S. reinsurer as exporting services and, as a result, excluded from income the net ceded premium received, while treating other items, including adjustments of reserves and the payment of the loss, the same as under current law. Thus, it is another example of potentially "asymmetrical treatment."

| Example 5A | | | |
|---|---|---|---|
| | Economic | Statutory | Tax |
| | | | |
| Reinsurance Premium | 1,000,000 | 1,000,000 | -- |
| Ceding Commission | (300,000) | (300,000) | -- |
| Initial Loss Reserve | (600,000) | (600,000) | (600,000) |
| | | | |
| Losses Paid | (600,000) | (600,000) | (600,000) |
| Reserve Adjustment for losses paid | 600,000 | 600,000 | 600,000 |
| | | | |
| Income (Loss) | 100,000 | 100,000 | (600,000) |
| | | | |
| Tax Liability | | | 0 |
| | | | |
| Loss carryforward | | | (600,000) |

Although the blueprint states that it is intended to alleviate the tax on exports, this approach might seem to go too far by potentially creating permanent tax benefits through providing tax losses of $600,000, compared to $100,000 of net economic and statutory income.

It also seems possible that the DBCFT could allow the deduction for the ceding commission as well, with the result that the loss carryforward could increase to $900,000.

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**Example 5B: treatment as import of risk:** This example assumes the U.S. reinsurer is taxed as importing risk and as a result would lose the deduction for the cross-border payment of losses.

| **Example 5B** | | | |
|---|---|---|---|
| | **Economic** | **Statutory** | **Tax** |
| | | | |
| Reinsurance Premium | 1,000,000 | 1,000,000 | 1,000,000 |
| Ceding Commission | (300,000) | (300,000) | (300,000) |
| Initial Loss Reserve | (600,000) | (600,000) | (600,000) |
| | | | |
| Losses Paid | (600,000) | (600,000) | -- |
| Reserve Adjustment for losses paid | 600,000 | 600,000 | 600,000 |
| | | | |
| Income (Loss) | 100,000 | 100,000 | 700,000 |
| | | | |
| Tax Liability | | | 140,000 |
| | | | |

It seems possible that the DBCFT could also disallow the deduction for the ceding commission, with the result that the income could increase to $1,000,000 and tax to $200,000.

This approach – treating the transaction asymmetrically and treating the transaction as a transfer of a good rather than a service, would provide a disincentive for U.S. insurers to reinsure foreign risk.

**Example 6: Inbound reinsurance: Non-U.S. direct writer cedes 100% of non-U.S. risk to U.S. reinsurer—Symmetrical treatment**

This examines what might result if the DBCFT both excluded the net ceded premium received by the U.S. reinsurance provider and allowed no deduction for the losses paid or the ceding commission.

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| **Example 6** | | | |
|---|---|---|---|
| | **Economic** | **Statutory** | **Tax** |
| | | | |
| Reinsurance Premium | 1,000,000 | 1,000,000 | -- |
| Ceding Commission | (300,000) | (300,000) | -- |
| Initial Loss Reserve | (600,000) | (600,000) | (600,000) |
| | | | |
| Loss Paid | (600,000) | (600,000) | -- |
| Reserve Adjustment for losses paid | 600,000 | 600,000 | 600,000 |
| | | | |
| Income (Loss) | 100,000 | 100,000 | 0 |
| | | | |
| Tax Liability | | | 0 |

In this example the DBCFT could provide an exclusion from tax only of the net income—$100,000—from the cross-border reinsurance provided by a U.S. reinsurer. This seems consistent with the general concept that revenue from exports (in this case, an export of (re)insurance services) is exempt from U.S. tax.

If this transaction was treated as the import of risk, it is unclear how it would be taxed, but it seems likely that it could be taxed similarly to the asymmetrical approach described in 5B, except perhaps there would be no inclusion of the reserve adjustment for losses paid, with the result that there could be $100,000 of income and $20,000 of tax under the DBCFT. It is unclear whether this is the correct analysis, especially considering our assumption that the reserve rules of current law would not change under the DBCFT.

**Example 7: Multiple-year transactions: U.S. direct writer of U.S. risk—Losses paid after year 1**

This example is the same as Example 1, but assumes that premium is collected in year 1 and the losses are paid in year 2.

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| **Example 7** | Year 1 | | | Year 2 | | |
|---|---|---|---|---|---|---|
| | **Economic** | **Statutory** | **Tax** | **Economic** | **Statutory** | **Tax** |
| | | | | | | |
| Premium | 1,000,000 | 1,000,000 | 1,000,000 | | | |
| Expenses | (300,000) | (300,000) | (300,000) | | | |
| Initial Loss Reserve | (600,000) | (600,000) | (600,000) | | | |
| | | | | | | |
| Loss Paid | | | | (600,000) | (600,000) | (600,000) |
| Reserve Adjustment for losses paid | | | | 600,000 | 600,000 | 600,000 |
| | | | | | | |
| Income (Loss) | 100,000 | 100,000 | 100,000 | 0 | 0 | 0 |
| | | | | | | |
| Tax Liability | 0 | 0 | 20,000 | | | 0 |

This demonstrates that in the wholly domestic context, the timing of the income and tax payments is the same as if the transaction had occurred in a single year. This is the result of the assumptions made about the potential treatment of reserves under the DBCFT.

This timing of income and tax payments could also be consistent when (i) a U.S. direct writer cedes 100% of the U.S. risk to a U.S. reinsurer (Example 2); (2) a U.S. direct writer cedes 100% of the U.S. risk to a non-U.S. reinsurer with asymmetrical treatment (import of services) (Example 3A); and (3) a non-U.S. direct writer cedes 100% of non-U.S. risk to a U.S. reinsurer with asymmetrical treatment (export of services) (Example 5A). There would be the same amount and timing of tax regardless of whether the transactions happened in a single year or across multiple years.

The timing of deduction of losses would change when a U.S. direct writer cedes 100% of the U.S. risk to a non-U.S. reinsurer with asymmetrical treatment (export of risk) (Example 3B).

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**Example 8: Outbound reinsurance of U.S. risk to non-U.S. reinsurer—Losses paid after year 1—Symmetrical treatment**

This example is the same as Example 4, but assumes that premium is collected in year 1 and the losses are paid in year 2:

| Example 8 | Year 1 | | | Year 2 | | |
|---|---|---|---|---|---|---|
| | Economic | Statutory | Tax | Economic | Statutory | Tax |
| | | | | | | |
| Premium | 1,000,000 | 1,000,000 | 1,000,000 | | | |
| Expenses | (300,000) | (300,000) | (300,000) | | | |
| Initial Loss Reserve | (600,000) | (600,000) | (600,000) | | | |
| | | | | | | |
| Ceded Premium | (1,000,000) | (1,000,000) | -- | | | |
| Reserve adjustment for ceded reserves | 600,000 | 600,000 | 600,000 | | | |
| Ceding Commission | 300,000 | 300,000 | -- | | | |
| | | | | | | |
| Loss Paid | | | | (600,000) | (600,000) | (600,000) |
| Reserve Adjustment for losses paid | | | | 0 | 0 | 0 |
| Ceded Loss Recovery | | | | 600,000 | 600,000 | -- |
| | | | | | | |
| Income (Loss) | 0 | 0 | 700,000 | 0 | 0 | (600,000) |
| | | | | | | |
| Tax Liability | | | 140,000 | | | 0 |
| | | | | | | |
| Loss carryforward | | | | | | (600,000) |

In this example, assuming the transaction was treated as the import of a service, the same amount of income would be recognized over time as compared to when premium and losses were paid in the same year: $100,000. This again could result in the U.S. direct writer being subject to tax on the underwriting income in the U.S. despite the transfer of that risk to a foreign domiciled reinsurer. Moreover, the elimination of a net operating loss carryback in the DBCFT could put the taxpayer in a position similar to the asymmetrical treatment described in Example 3A. This example highlights the additional tax costs that could arise under this approach for U.S. insurers ceding long-tail insurance cross-border. A similar effect is implied for outbound reinsurance of low-likelihood, high-loss insurance such as catastrophe policies.

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**Example 9: Inbound reinsurance of non-U.S. risk by U.S. reinsurer—Losses paid after year 1—Asymmetrical import of risk treatment**

This example is the same as Example 5B, in which reinsurance of a non-U.S. risk by a U.S. reinsurer is treated in an asymmetrical manner and treated as an import of risk, but assumes that premium is collected in year 1 and the losses are paid in year 2:

| **Example 9** | **Year 1** | | | **Year 2** | | |
|---|---|---|---|---|---|---|
| | **Economic** | **Statutory** | **Tax** | **Economic** | **Statutory** | **Tax** |
| | | | | | | |
| | | | | | | |
| Reinsurance Premium | 1,000,000 | 1,000,000 | 1,000,000 | | | |
| Ceding Commission | (300,000) | (300,000) | (300,000) | | | |
| Initial Loss Reserve | (600,000) | (600,000) | (600,000) | | | |
| | | | | | | |
| Losses Paid | | | | (600,000) | (600,000) | -- |
| Reserve Adjustment for losses paid | | | | 600,000 | 600,000 | 600,000 |
| | | | | | | |
| Income (Loss) | 100,000 | 100,000 | 100,000 | | | 600,000 |
| | | | | | | |
| Tax Liability | | | 20,000 | | | 120,000 |

In this example, the same aggregate amount of income ($700,000) as in Example 5B is realized, but timing of the income is changed by the timing of the transaction.

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**Example 10: Inbound reinsurance of non-U.S. risk by U.S. reinsurer— Losses paid after year 1—Symmetrical treatment**

This example is the same as Example 6, in which the cash flows from reinsurance of a non-U.S. risk by a U.S. reinsurer are treated symmetrically, but assumes that premium is collected in year 1 and the losses are paid in year 2. This example assumes the 90% limitation on NOL offset proposed in the blueprint would apply:

| **Example 10** | **Year 1** | | | **Year 2** | | |
|---|---|---|---|---|---|---|
| | **Economic** | **Statutory** | **Tax** | **Economic** | **Statutory** | **Tax** |
| | | | | | | |
| | | | | | | |
| Reinsurance Premium | 1,000,000 | 1,000,000 | -- | | | |
| Ceding Commission | (300,000) | (300,000) | -- | | | |
| Initial Loss Reserve | (600,000) | (600,000) | (600,000) | | | |
| | | | | | | |
| Losses Paid | | | | (600,000) | (600,000) | -- |
| Reserve Adjustment for losses paid | | | | 600,000 | 600,000 | 600,000 |
| | | | | | | |
| Income (Loss) | 100,000 | 100,000 | (600,000) | | | 600,000 |
| Income after NOLs | | | | | | 60,000 |
| Tax Liability | | | | | | 10,800 |
| | | | | | | |
| Loss carryforward | | | (600,000) | | | (60,000) |

In this example, assuming treatment as an export of services, the timing of loss and income is different than in the single year example, but because income could be realized in a later year, losses recognized in the earlier year could be available to reduce income. However, the proposed 90% limitation on NOL offset could result in residual taxation in year 2.

If this transaction was treated as an import of risk, it seems possible that the transaction could be treated similarly to Example 9, but that no inclusion of the reserve adjustment for losses paid would apply, so that there could be $100,000 of income and $20,000 of tax under the DBCFT, with no change in the timing of income or tax. Again, it is unclear whether this is the correct analysis, especially considering our assumption that the reserve rules of current law would not change under the DBCFT.

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## Conclusion

The preceding discussion shows that a DBCFT, if enacted, could apply in a number of different ways to cross-border reinsurance. Even these simplified examples demonstrate that fundamental choices could introduce significant changes in the U.S. insurance market. The unique nature of insurance transaction flows, and financial transaction flows in general, have led many countries with VATs to provide exemption or zero rating to some transactions for VAT purposes. While this might avoid some of the issues described above, it is not necessarily the best or only approach and may be partially driven by other considerations. When crafting rules to achieve the policy goals of the blueprint, it would be important for U.S. policy makers to take note of the issues described above when considering the insurance industry. As indicated at the outset of this paper, KPMG takes no position on whether the DBCFT, including the border adjustment, should be adopted or should apply to insurance and reinsurance transactions. Our purpose in this paper is to highlight areas of application and policy that should be addressed as specific legislative proposals are being discussed.

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