Will Switzerland be more attractive under Neal Bill?

Progress on the Neal Bill is slow, LARS GERSPACHER and CHRIS BELL reveal, but is still managing to produce results

THE WORDS "Neal" and "Bill" have been known on occasion to have the same effect on certain global reinsurers as the proverbial "red rag to a bull".

In a nutshell, internationally operating insurers have so far been able to lower their US tax exposure fairly simply. To achieve this benefit, a primary insurer writing insurance business in the US would cede a large portion of its risks to an affiliated reinsurer based in an offshore and "tax-friendly" jurisdiction, such as Bermuda, and pay a substantial reinsurance premium to that reinsurer.

Any profits on the business ceded would be, from a corporate group perspective, made mainly in Bermuda, where no taxes are levied on earnings.

Congressman Richard Neal has made a number of attempts over the years to close what some see as a loophole. HR3424, or the so-called "Neal Bill", if it passes through Congress, would disallow deductions for a portion of reinsurance premiums, if those are paid directly or indirectly to an affiliated reinsurer that is not subject to US federal income tax.

Although opponents of the Neal Bill have often repeated their view the bill will quickly vanish from the scene, latest developments indicate this might not be the case. On July 14, a first hearing before the US House ways and means committee took place. On the table was the taxation of reinsurance between affiliated entities where the Neal Bill was the main topic.

Not only is the Neal Bill still very much in focus, but the Obama administration has seized on Neal's idea and included in the administration's fiscal-year 2011 budget a proposal designed to address the incentives created by existing US tax rules and to level the playing field between US-owned and foreign-owned groups insuring US risks.

The budgeted receipts resulting from the proposal are, however, considerably lower than the expected effects of the Neal Bill.

Effect on the Swiss market

Switzerland has, of late, become a popular destination for reinsurers that are fleeing or thinking of fleeing certain offshore jurisdictions in anticipation of the potential new tax regime. Some corporate groups have already reorganised their corporate structure by moving their reinsurance carrier to Switzerland; others have such a move under strong consideration.

While it is hardly comparable to the minimum speed a participant in the Pamplona run must achieve to be sure of taking part in next year's race, the tempo of this movement is somewhat faster than the pace of progress of the Neal Bill itself.

The process is known here as "redomestication", since under Swiss corporate law it is possible to move a foreign-domiciled company into Switzerland without dissolving it.

Most of the operations have, however, been moved into Switzerland by way of an international merger, which is also permitted under the Swiss Merger Act.

For example, in May 2007, Paris Re moved its Bermuda holding to Zug. In September 2008, Paris Re Bermuda Ltd was merged into a Swiss reinsurance company, called Paris Re Switzerland, by means of an international merger, without dissolving either of the two parties.

Ace Ltd (the holding company) moved its domicile from the Cayman Islands to Zurich in July 2008 in a classic redomestication. In September 2008, Ace also established two risk carriers in Switzerland, for reinsurance and primary insurance business.

The latter, Ace Insurance (Switzerland) Ltd, increased its capital and took over the assets and liabilities of Ace European Group in London. This was done through an international merger.

Flagstone Re set up a Swiss company in Martigny/Switzerland and, in September 2008, merged its Bermuda business into the Swiss company. Flagstone Re Bermuda is now a branch of the Swiss reinsurer.

More participants and potential participants are joining or strongly considering joining the move in this direction; Amlin and Catlin have recently announced plans to form Swiss reinsurance companies and others are said to be considering following.

Switzerland: more certainty?

One of the main reasons to move business from offshore centres such as Bermuda to Switzerland, from a legal perspective, is the double taxation treaty between Switzerland and the US.

US tax advisers feel a working double taxation treaty between the US and a contracting state, which also imposes income taxes, would give them a considerably better position to lobby in favour of an exemption.

Some reinsurers based in certain offshore centres have decided to be proactive, however; to anticipate some of the expected changes in the legal environment and to avoid such discussions. Whether or not a Swiss-based reinsurer will escape entirely the potential new US tax regime remains to be seen, of course.

No excise taxes

There are other reasons to redomesticate business to Switzerland. The protocol to the double tax treaty between Switzerland and the US with reference to business profits states the US tax on insurance premiums paid to foreign insurers shall not be imposed on insurance or reinsurance premiums that are the receipts of a business of insurance carried on by an enterprise of Switzerland, whether or not that business is carried on through a permanent establishment in the US.

In other words, based on the double tax treaty Swiss companies that reinsure US risks are exempt from the US Federal Excise Tax on gross premiums. There are only few US double taxation treaties that contain a similar provision (such as those with Germany and the UK).

Furthermore, Switzerland levies taxes only on income arising in Switzerland. If a Swiss company has a branch abroad, profits made there are, in principle, not assessed in Switzerland. If a Swiss reinsurer, for instance, maintains offices in Bermuda, profits made by such branch are not taxable in Switzerland.

Excise taxes are not levied on the premiums because the premiums go, nevertheless, to a Swiss company and would fall under the tax treaty regulation between Switzerland and the US. In other words, you can have your cake and eat it too.

Employment

Switzerland has ready access to a pool of employees who are well educated, experienced and multilingual. That pool, owing to Switzerland's bilateral agreement with the European Union (EU) and the Schengen Agreement, extends far beyond its own citizens, and the agreements help to ease the position in the case of spouses of employees who also wish to continue their careers while living here, provided they hold the correct citizenship.

A glance at Liechtenstein

The Principality of Liechtenstein has also become a more important place in the insurance world, because it plays a unique role in Europe. Unlike Switzerland Liechtenstein is a member of the European Economic Area (EEA).

As a result, every insurer and reinsurer is able to take benefit of the freedom to provide services within the EEA. Liechtenstein also has a bilateral treaty with Switzerland according to which both countries recognise the supervisory authority of the other country.

Liechtenstein is, therefore, the only country in Europe from which the whole EEA (including the EU) and Switzerland can be covered by one licence.

Hence, one sensible concept in the past for start-up insurers has been to set up a reinsurance carrier in Switzerland and a primary insurer in Liechtenstein. That was the concept of Glacier Re, which recently sold its primary insurance company to Torus.

It is not a case of redomestication, but is still a good example of how a reinsurance and new primary insurance business can be sensibly established. The reinsurance carrier was established in Switzerland, while the carrier for primary insurance was established in Liechtenstein. Liechtenstein does not require any minimum retention, so a large percentage of the business written by a Lichtenstein carrier can be ceded to a Swiss reinsurer.

While it is not clear to what extent Swiss reinsurers will be protected by the double tax treaty from the impact of the Neal Bill or the administration's proposal, redomestication is and will remain a hot topic in Switzerland for the near future.

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LEGAL BRIEF

BARLOW LYDE & GILBERT

Law Commissions weigh up reform of section 53 of MIA

IN THE eighth of their series of issues papers on proposals for reform of insurance law, the Law Commission of England and Wales and the Law Commission of Scotland have concentrated on s53 of the Marine Insurance Act 1906 (MIA), a provision of particular relevance to the marine insurance market.

That particular section of the MIA makes the broker directly responsible to the insurer for the payment of the premium, irrespective of whether or not the broker has actually been put in funds by the insured.

MIA s53(1) states: "Unless otherwise agreed, where a marine policy is effected on behalf of the assured by a broker, the broker is directly responsible to the insurer for the premium, and the insurer is directly responsible to the assured for the amount which may be payable in respect of losses, or in respect of returnable premium."

The original reasoning behind this rule was the insurer should be protected against the credit risk of an insured known only to the broker.

The consequences for the insurer if the broker becomes insolvent are not, however, dealt with. In addition, case law supports the position the insurer cannot refuse to pay a valid claim simply because a broker has not transferred the premium. It is up to the parties to include clear language in the policy wording if they agree to reverse this default position.

As regards the inclusion of premium payment warranties in marine insurance policies, there has been debate over their effectiveness. It remains unclear whether an insurer can rely on such a warranty where a broker has gone into liquidation, has sued an insured for unpaid premium but that premium has subsequently been passed to the broker's creditors.

The insurer may not be able to recover the premium but there is a risk it could still be required to pay the insured's claims, irrespective of the inclusion of the premium payment warranty in the policy.

It is probable s53(1) only applies to marine insurance. In circumstances where the provision has no application, a broker acting within the scope of its authority will not, generally, be held liable to the insurer for the premium.

Instead, the insured (the broker's principal) is liable and remains so even if it has transferred the premium to its agent but the broker has not passed those funds on to the insurer.

The Law Commissions view the application of s53(1) as unclear. They question the justification for the continued existence of the section in the marine market.

Why should the broker be personally liable in that context but not the non-marine market?

The Law Commissions consider terms of business agreements are unlikely to resolve all of the outstanding issues because insureds are not party to them.

The Law Commissions have concluded the default position should be insureds be liable for the premium for the cover from which they benefit and the broker only be liable if it has expressly assumed such liability. The commissions have not spelt out how they would propose achieving this reform.

A simple repeal of s53(1) could, the commissions argue, result in uncertainty. It might be necessary to replace the section with a new statutory provision.

As with all of the Law Commissions' proposals, interested parties have been invited to comment.

It will be of interest to hear whether there is a real concern about the continued existence of this provision, including concern as to the potential credit risk posed by brokers to insurers and by insureds to brokers.

The Law Commissions and interested parties will also be making their own cost/benefit analysis of implementing both the reforms set out in this and the commissions' earlier papers.

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