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OFFSHORE TAX ISSUES: REINSURANCE AND HEDGE FUNDS

HEARING

BEFORE THE

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OFFSHORE TAX ISSUES: REINSURANCE AND HEDGE FUNDS

WEDNESDAY, SEPTEMBER 26, 2007

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:05 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Conrad, Lincoln, Wyden, Salazar, Grassley, Hatch, Lott, Bunning, and Roberts.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

Benjamin Franklin said, "In this world, nothing can be said to be certain, except death and taxes."

Today we will examine how some folks are going far afield in this world to make their taxes far less certain. We will look at how people go offshore to avoid taxation in three settings: insurance, hedge funds, and personal compensation.

The first setting that we will examine is insurance. Insurance companies make a living by doing two things: they assess premiums based on the prediction of the likelihood of events against which they insure—that is called underwriting—and they also make money by investing the premiums that they collect until they have to pay out claims. If they are good at those two jobs, they make a profit.

Customers buy insurance from insurance companies to guard against the risk of fire, disaster, or some other calamity. In exchange for paying premiums, the customers shift some of their risk to the insurance companies. Insurance companies also buy insurance. Property and casualty insurance companies pay premiums to reinsurance companies in exchange for shifting some of their risk to the reinsurance company.

Sometimes the reinsurance company is also the parent company of the property and casualty insurance company. In that case, the property and casualty insurance company shifts risk to their parent reinsurance company at something less than an arm's length transaction.

Here is where the tax avoidance comes in. Some parent insurance companies set their headquarters in low-tax jurisdictions, like Bermuda. Subsidiary property and casualty insurance companies shift risk to the Bermuda parent. Because of Bermuda's low tax burden, the Bermuda parent can get a greater after-tax return on their investment activities.

As a result, subsidiary property and casualty insurance companies can charge lower premiums for their insurance. They get a competitive advantage over insurance companies doing business in jurisdictions that tax investments.

The second setting that we will examine today involves hedge funds. Foundations and other nonprofits are some of the largest investors in the world. The law requires a nonprofit investor that invests directly in hedge fund partnerships to pay the unrealized business income tax, otherwise known as UBIT.

The policy behind the law is that tax-exempt entities should not be able to have an unfair advantage over taxpaying entities doing the same thing. To avoid UBIT, nonprofit investors sometimes invest in hedge funds through offshore entities incorporated in low- or no-tax jurisdictions, such as the Cayman Islands or Bermuda. These offshore entities are called blockers.

The third setting we will examine today is the compensation of hedge fund managers. Hedge fund managers receive fees from offshore blocker corporations used by nonprofits and foreign investors. Some hedge fund managers elect to defer their income, and deferring income means you pay taxes later, which is the same as a significant tax savings.

In each of these three settings, people can argue that there are legitimate business reasons for the offshore transaction, and in each of these three settings people can legitimately question whether someone is avoiding paying their taxes.

So today we will see whether Ben Franklin was right about the certainty of taxes in this world. We will see whether there are parts of this world where people can get away without paying taxes, and we will examine whether this is something, unlike death, that we can do something about.*

Senator Grassley?

OPENING STATEMENT OF HON. CHUCK GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Thank you, Mr. Chairman, for this hearing on a very important subject that involves not only tax policy, but the competitiveness of our businesses and services in this country.

Because we are an increasingly global economy, U.S. businesses face foreign competitors here at home, as well as in foreign markets. Under our system of taxing active business income, U.S.-owned businesses are taxed on their worldwide income, but deferral for active income helps them then to better compete in the foreign markets.

We tax foreign-owned businesses only on their income that is sufficiently connected to the United States. Now, concern about competition in the U.S. market often focuses on rules to prevent foreign-owned businesses from inappropriately stripping their U.S. tax base. The earnings stripping rule provides one example.

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*For additional information on this subject, *see also,* "Present Law and Analysis Relating to Selected International Tax Issues," Joint Committee on Taxation staff report, September 24, 2007 (JCX–85–07).

Our international tax system can affect the competitiveness of U.S. businesses, both here and abroad. The insurance industry, which we are examining today, is one illustration of that fact. To help U.S. insurers compete in foreign markets, the tax code allows them to defer U.S. tax on their active foreign insurance income. This rule expires after 2008, but it has broad bipartisan support.

In U.S. markets, however, domestic insurers have revived the claim that our tax rules place them at a disadvantage relative to their foreign-based competitors. Our tax code has rules designed to address this issue. But if there is a problem, then by definition those rules would be inadequate.

The reinsurance business is primarily located in London, in Germany, in Switzerland, and in Bermuda, but Bermuda has received the most attention. One industry publication refers to the Bermuda reinsurance model as the "better mousetrap" for insuring U.S. risk because of its tax efficiency.

Proponents of change are not pushing for tax relief for themselves to level the playing field. Instead, they are pushing to change the way their foreign-based competitors are taxed. But let us not put the cart before the horse. Before we try to figure out how to solve a problem, we need to determine whether or not a problem exists, and, if so, we need to define it better. This hearing is part of that analysis.

The other two issues we will be examining relate to offshore hedge funds. We have all seen the picture of the Ugland House in the Cayman Islands as a registered address for—can you believe it?—12,748 companies. A good number of those companies are there because of hedge fund investment structures that they have.

Speaking of tax-efficient mouse traps, hedge funds are structured in a very tax-efficient manner. Each structural component serves a specific tax objective. U.S. taxable investors invest through a partnership, and the manager is compensated with carried interest.

For the investor, this serves the objective of permitting de facto deduction for the manager's fees that would otherwise be limited. For the fund manager, it permits some conversion of ordinary income to capital gains and avoidance of Medicare tax.

On the other side of the structure, foreign and tax-exempt investors, like pension plans and university endowments, invest in hedge funds through offshore blocker corporations, and the fund manager receives, then, an incentive fee. By using this structure, the tax-exempt investor avoids unrelated business taxable income, while the fund manager is able to defer tax on a non-limited portion of the incentive fee through a non-qualified deferred compensation arrangement.

This committee should analyze the underlying policy of the debt financing rules. I am concerned that tax-exempt organizations are so easily able to plan around those rules with offshore structures. We should also examine these deferred compensation arrangements. We will be looking at these issues at this hearing, and so that is why it is very important, Mr. Chairman, for us to recognize your leadership on bringing these things to our attention and bringing some rationale behind it.

Thank you.

The CHAIRMAN. Thank you, Senator, very much.

Our first witness this morning will be Senator Dorgan, who has been an outstanding leader on the issue of offshore tax havens.

Welcome, Senator, to the committee. You have done a lot of work in this area, and we are delighted to hear from you.

STATEMENT OF HON. BYRON L. DORGAN, A U.S. SENATOR FROM NORTH DAKOTA

Senator DORGAN. Mr. Chairman, thank you very much. I will be mercifully brief. I know you have another panel this morning. But thank you for allowing me to say a few words,

First of all, I think that your attention to tax havens, tax avoidance, and tax abuse is very important, and I appreciate the committee's work on it. I want to, because of the opening statements, make one point before I talk about three pieces of legislation.

That point is, there is a fair amount of discussion around these days that the United States has one of the highest corporate tax rates, and therefore we are anti-competitive or we are put at a competitive disadvantage internationally. I obviously understand why that is moving around and the urgency of it from the standpoint of some.

It should be noted, however, that the issue is not tax rates. The issue is, what is the effective tax burden that is paid? In fact, while we perhaps do have higher tax rates than some other countries, the effective tax burden that is paid in this country puts us right near the bottom of the 29 or so OECD countries.

The effective tax rate paid in this country by corporations is not the 35 percent rate. It is somewhere around 17 to 18 percent. So I just wanted to make that point, because there is this urgency about the notion that somehow we are anti-competitive because of the rates. The taxes paid are what is important.

And part of the reason we have lower tax burdens is because of the things that you are holding hearings on, and that is, tax avoidance. Let me talk about several areas. We are at war, and still there is a thriving, aggressive industry in our country to figure out ways that people and enterprises could avoid paying taxes to our government.

I think my colleague from Iowa mentioned this chart I brought you, which many of us have used—I used it a couple of years ago in a book I wrote—"Five-Story Cayman Islands Building Called Ugland House Home to 12,748 Companies."

Incidentally, that is from some enterprising reporting by a Bloomberg reporter named David Evans. I called David Evans when I first saw this a couple of years ago. He went down to the Cayman Islands, and that is a pretty enterprising piece of reporting, because I think it can be called disgusting when you take a look at that, a 5-story white building that is the official home to 12,748 corporations.

There is only one reason for them to have a fictitious address in the Cayman Islands, and that is to avoid paying taxes. That is the heart of what I want to talk about with respect to three pieces of legislation that I hope you will consider as you take a look at the agenda that you have today, and in the future.

One is on curbing U.S. corporate subsidiaries' offshore tax haven abuses, S. 396, that I have put together with a couple of colleagues.

As you know, this committee passed legislation that addressed the problem of corporate inversions some years ago, but frankly that is just really the tip of the iceberg. U.S. companies routinely are setting up foreign tax haven subsidiaries offshore to avoid paying their taxes to this country.

The *New York Times* had a report that I think hit it on the head. Instead of moving headquarters offshore, many companies are simply placing patents on drugs, ownership of corporate logos, techniques for manufacturing processes, and other intangible assets in tax havens. Then, they charge their subsidiaries in higher tax locales, including the U.S., for the use of these intellectual properties. That allows the companies to take profits in these tax havens and pay far less in taxes.

You know of a report that we had done. Fifty-nine of the 100 largest publicly traded companies that have a lot of contracts with the Federal Government had established hundreds of offshore subsidiaries in tax haven countries.

So even while they are aspiring to do business with the Federal Government, they are at the same time, on the other hand, finding ways to avoid paying taxes by establishing offshore tax havens. The Enron Corporation, of course, was the poster child for many of these. They had 441 subsidiaries in the Cayman Islands alone.

So let me thank you for your work on those issues and ask you to consider S. 396. S. 396 will essentially say, if you are moving your businesses to a tax haven but you are not really moving businesses, just paper, and you are not engaged in real and active business in the tax haven, we tax your tax haven subsidiary as a domestic company.

If you have real and active business in that tax haven, this legislation would not impact you. I think that would be a piece of legislation that would have great merit in shutting down some of these perverse strategies to avoid paying taxes.

Second, very quickly, the issue of runaway plants. As you know, we now have an incentive that says, close your business, get rid of your employees, move your production overseas, and we will give you a tax break. I do not propose that we alter all of that, but I propose this. If you close your plant, get rid of your employees, move your production overseas, and then ship that production back into this marketplace, you lose deferral for that portion of income. If your strategy is to exercise opportunity in our marketplace by moving your production elsewhere, you should not be able to gain the tax deferral break as a result of that opportunity.

So I do not propose we end all deferral, but I propose we end deferral opportunities in that circumstance, because we really do provide a tax break now for people who decide they are going to move their production and sell back into this country—and, by the way, we will give you a tax break for doing it.

Finally, on the issue of SILOs, first of all, thank you for the work you have done on that. I think this committee should be complimented. I would suggest, however, perhaps what is considered a more radical approach, and that is to move the effective date.

If, in fact, the Sale-In/Lease-Out transaction by which a U.S. bank purchases a sewage system in Germany is abusive prospectively, it is also abusive retroactively. We have effectively said, with legislation that has been passed, you cannot do it anymore, it is wrong. But those transactions, up to a certain date, we will recognize.

I think things that are abusive prospectively are abusive retroactively, and I seldom ever counsel that we do things retroactively in the tax code. This, clearly, is one where we ought to shut it all down and do it now.

So let me thank you for accepting my testimony. I served on the House Ways and Means Committee for 10 years, and, as Senator Conrad was, was Tax Commissioner for my State. I have a significant interest in these issues, and I appreciate very much the attention to some of these issues at this morning's hearing, and Mr. Chairman and Ranking Member, at other hearings that you have had as well. I think this is a very important issue to tackle.

The CHAIRMAN. Thank you, Senator, very much. You have made a major contribution.

[The prepared statement of Senator Dorgan appears in the appendix.]

The CHAIRMAN. I also want to acknowledge the contribution to the investigation of offshore tax havens by Senators Levin and Coleman, the Permanent Subcommittee on Investigations.

Senator DORGAN. That is correct.

The CHAIRMAN. They have done a lot of work here, and they have asked me to so acknowledge. I gladly told them I would. They are doing great work.

Senator DORGAN. Senator Levin is a co-sponsor of S. 396 as well.

The CHAIRMAN. Right. Thank you, Senator, very much. I appreciate it.

I would now like to introduce our next panel. The first witness is William Berkley, founder and chairman of the insurance company, W.R. Berkley Corporation. Then Donald Kramer, chairman and CEO of Ariel Reinsurance, Limited. The third witness is Suzanne Ross McDowell, partner in the law firm of Steptoe and Johnson. Next, Daniel Shapiro from London, a partner in the law firm of Shulte, Roth, and Zabel. Next, Dr. Jane Gravelle of the Congressional Research Service, who will discuss her research on endowments and college tuition. The last witness is Lynne Munson, from the Center for College Affordability and Productivity.

Thank you all for coming. Your full statements will automatically be included in the record, but I urge you to keep your oral statements to 5 minutes. Since we have so many witnesses here this morning, I will be enforcing that rule a little more strictly.

Mr. Berkley?

STATEMENT OF WILLIAM R. BERKLEY, CHAIRMAN, PRESIDENT, CEO, AND COO, W.R. BERKLEY CORPORATION, GREENWICH, CT

Mr. BERKLEY. Mr. Chairman, Ranking Member Grassley, and members of the committee, I am pleased to appear before you today to discuss a serious problem in our current tax system, a problem that provides a significant competitive advantage to certain foreign property and casualty insurance companies that have a capital base in no-tax or low-tax countries.

Reinsuring from a subsidiary in the United States to a parent or affiliate located in a tax-favorable jurisdiction allows our foreign-domiciled competitors to avoid paying tax on both underwriting and investment profits on much of their business written in the U.S.

This problem, which originated in practice approximately 20 years ago, has already caused significant migration of insurance capital abroad. If left unchecked, this will cause much more of the U.S. capital base to migrate abroad, and ultimately the future of our domestic insurance industry will be threatened.

This is clearly one of the most important issues faced by my company since I founded it over 40 years ago. I am presently chairman and chief executive of W.R. Berkley Corporation, one of the country's largest commercial lines property and casualty insurance providers. We do in excess of $5 billion in premiums, and have assets of over $15 billion.

But I am not here representing just my company, but also a coalition of U.S.-domiciled insurers who write the majority of commercial insurance in the United States. Our members include some of the largest companies, as well as a number of middle-sized companies. These companies employ over 150,000 people and have assets in excess of a trillion dollars.

The property and casualty industry is critical to the U.S. economy. It is the segment of the financial service sector that allows all others to operate with enough predictability to give confidence to the lenders and investors.

The problem today is, foreign-domiciled insurers are able to write the exact same business as my company through U.S. subsidiaries and can escape paying much U.S. tax by reinsuring this business, directly or indirectly, to an affiliate located in a tax-favored location. Thus, two companies can write exactly the same business at the same price, and the foreign-domiciled company will move their profits out of the reach of our tax system through a contract with itself and a bookkeeping entry.

The result of such transactions, which over the past 10 years have grown from $4 billion to over $30 billion, is a loss of revenue of many billions of dollars to the U.S. Treasury. These offshore reinsurers are merely optimizing the results for their shareholders, but over the long run if the current situation continues, it will prove to be uneconomic for companies like mine, or other members of our coalition, to be effective competitors while domiciled in the U.S.

The legislation which we desire is not meant to disadvantage the offshore-domiciled companies, but is merely an attempt to help level the playing field. Of course, each of these non-U.S.-based groups always has the option of putting their U.S. business into a U.S. taxpayer.

A few facts that I would like to point out about the U.S. property and casualty business: it contributes 2.4 percent to the Nation's GDP; it has total assets of approximately $1.5 trillion; it accounts for 15 percent of all investments in municipal bonds; it directly employs 650,000 people, and indirectly employs an additional 1.5 million; and it pays more than $22 billion in taxes.

This concern is not without precedent. A little over 30 years ago, one of my company's operating units helped to organize the Reinsurance Association of America. Today, only two members of this association are U.S.-domiciled, ourselves and General Reinsurance.

Let us not have the direct insurance industry follow the path of the reinsurers. If no action is taken, there is the potential for significant long-run impact. As well, it will not necessarily be immediate, but could certainly be considerable over an extended period of time.

We could have increased cost of borrowings from municipalities, as the property and casualty industry no longer has reason to invest in municipal securities. It could have a more subtle impact when such an important industry no longer comes under the legal purview of our government and no longer has the same societal commitment.

I very much appreciate this committee's attention to this important matter. It warrants prompt action.

Senator GRASSLEY. Thank you, Mr. Berkley.

[The prepared statement of Mr. Berkley appears in the appendix.]

Senator GRASSLEY. Now, Mr. Kramer?

STATEMENT OF DONALD KRAMER, CHAIRMAN AND CEO, ARIEL REINSURANCE, HAMILTON, BERMUDA

Mr. KRAMER. Thank you. And thank you for allowing me to appear here. I am the chairman and CEO of a Bermuda reinsurance company, Ariel Reinsurance. I have been the CEO of a prior company that was formed in 1993 in response to Hurricane Andrew.

The fact is, business owners look to insurance to spread risk. That allows risk to be done at more efficient levels and at better costs. Reinsurance companies, in turn, allow insurance companies to spread risk. Therefore, there is a transfer of risk that keeps costs relatively or comparatively low.

The fact is, there is no free lunch. When you cede reinsurance, you cede risk. Reinsurance facilitates efficient operation. The reinsurance industry is used extensively within United States industry. A substantial percentage of U.S. insurers cede more than half of the gross premiums they write to reinsurers, and affiliate reinsurance is used routinely within the United States for valid reasons, not necessarily tax reasons.

Just for example, my distinguished colleague, Mr. Berkley, his affiliated companies cede between 3 and 100 percent of premium to affiliated companies within the group, so clearly there are substantial business reasons for ceding reinsurance to affiliates beyond simple tax considerations.

Reinsurance allows companies to pool risks and enables them to put the risk where capital is. More than half the reinsurance purchased each year by U.S. reinsurance companies happens to be from non-U.S. reinsurers. It is a global business.

Hurricane Katrina reinforced this point, since approximately 50 percent of the claims paid for Hurricane Katrina losses came from non-U.S. carriers. Bermuda companies alone generated 24 percent of those losses, and not one penny was offset by U.S. tax. It was ceded tax-free to the U.S. business.

The associated Bermuda insurers and reinsurers generate business income actually from more than 100 countries from around the world. It is certainly not correct to describe Bermuda as a market that solely serves the United States.

Now, the U.S. has experienced four insurance market crises over the last 30 years, when the U.S. industry was either unable or unwilling to provide insurance capacity. In each of those cases, the market responded to the crisis by providing capital for funds to create new reinsurers to fill the demand shortage. They had specialty expertise in catastrophe.

The principal area of that capital influx was to Bermuda. But why? It was simply because of ease of entry to Bermuda, which had a credible regulatory environment and had a sound operational infrastructure. That allowed reinsurance companies to enter the market on a timely basis. This was not possible in the United States under the highly fragmented and difficult State insurance regulatory system.

So Bermuda was there when the U.S. market needed us, following Hurricane Andrew, following the World Trade Center disaster, following Hurricanes Wilma, Rita, and Katrina, and in fact it began in 1983 when the U.S. market had a capacity shortage in excess liability, which led to the creation of ACE and XL (Bermuda's two largest insurers).

The Association of Bermuda Insurers and Reinsurers (ABIR) paid approximately $2 billion in losses from the 2001 U.S. terrorist attacks. It paid approximately $5 billion in claims from the 2004 Florida hurricanes, and approximately $17 billion in claims from 2005 Hurricanes Wilma, Rita, and Katrina. So collectively, in just 6 years these carriers paid $25 billion in catastrophe losses, and, as I said, not one penny was deducted from U.S. tax returns. That is just an important thing. We were there when it was needed.

According to an economic analysis provided to the association, Bermuda carriers' hurricane claims provided enough funds to rebuild 45,000 homes in Louisiana, 24,000 homes in Mississippi, and 12,000 homes in Florida. In addition to the claim statements for rebuilding businesses and lost income, Bermuda insurers helped return more than 9,000 employees to work in Louisiana and nearly 5,000 employees to work in Mississippi.

Not only that, in 2005, Bermuda carriers accounted for 57 percent of total net premiums written in the U.S. crop insurance market. In 2005, in Iowa the average Bermuda company wrote $36.5 million in coverage, enough to cover 3,150 farms. In total, Bermuda companies may insure more than 50,000 Iowa farms.

Now, 14 of the ABIR association members have U.S. subsidiaries. These companies are fully subject to U.S. taxation. The membership of ABIR and its affiliated companies employ 17,000 people around the world, including 9,600 in the United States. Our economic consultants estimate that our members' U.S. employees, in turn, lead to the employment of an additional 95,000 people.

We are always asked, why Bermuda? I said earlier, it was ease of entry. There is no free lunch. If there is ease of entry, there is also competition. That, in fact, becomes a self-regulating market.

The CHAIRMAN. I am going to have to ask you to summarize, please, Mr. Kramer.

Mr. KRAMER. I am sorry, sir.

All I can say is, Bermuda has become a source of capacity for the United States. It has lowered costs. And while people have tried to use the term "affiliate reinsurance" as comparable to "borrowing affiliates," the truth is, there is real risk transfer. Bermuda has maintained those risks and sustained losses in accordance with taking those risks.

Thank you so much. I am sorry for going over.

The CHAIRMAN. Thank you, Mr. Kramer, very much. Not a problem. Thanks very much.

[The prepared statement of Mr. Kramer appears in the appendix.]

The CHAIRMAN. Ms. McDowell?

STATEMENT OF SUZANNE ROSS McDOWELL, PARTNER, STEPTOE AND JOHNSON, LLP, WASHINGTON, DC

Ms. MCDOWELL. Mr. Chairman, Mr. Ranking Member, and members of the committee, thank you for inviting me to appear before you today. My name is Suzanne Ross McDowell. I am a partner in the law firm of Steptoe and Johnson here in Washington, DC. My practice focuses on the law of tax-exempt organizations.

In the 1980s, I served in the Office of Tax Policy at the Treasury Department and was responsible for issues relating to tax-exempt organizations, including issues relating to debt-financed income rules.

Since leaving the Treasury Department, I have written academic papers and given presentations on this subject. My testimony today will focus on the debt-financed income rules. It represents my views, not those of my law firm, any client, or any other organization.

Let me begin with a brief overview of current law. For over 50 years, congressional policy has been to exclude most types of investment income from the Unrelated Business Income Tax (UBIT). However, if the investment income is derived from property that was acquired with debt, the income is taxed under the debt-financed income rules. Thus, these rules are an exception to the general congressional policy of exempting investment income of tax-exempt organizations from tax.

The original purpose of the debt-financed income rules, however, was not so broad. Rather, when enacted in 1969, these rules were intended to foreclose abusive sale/leaseback transactions that permitted businesses to sell property to tax-exempt organizations in transactions that converted ordinary income of the business to capital gains and allowed the tax-exempt purchaser to buy the property over time, while investing little or none of its own capital.

As is well known, the unrelated debt-financed income rules can be avoided on securities and financial products by investing through foreign corporations referred to as blocker entities.

At first blush, blocker entities look like a loophole that should be shut down. However, blocker entities are frequently used to avoid the application of the debt-financed income rules to legitimate, nonabusive transactions that were not the intended target of the rules.

Thus, before taking action on blocker entities, it makes sense to look at the policy and impact of the unrelated debt-financed income rules. These rules tax all debt-financed investments of tax-exempt organizations, even though they were enacted for the purpose of foreclosing abusive sale/leaseback transactions.

The current breadth of application would be justified only if all leveraged investments of tax-exempt investors should be discouraged. The purpose of leverage is to increase an investor's return on investment. The trade-off for the increased return is taking on greater risk. The increased risk of an individual investment, however, can be reduced through diversification in the investor's portfolio and by hedging.

Furthermore, investments that do not use leverage may be as risky, or even riskier, than leveraged investments. Thus, taxing all debt-financed income is not an effective way to protect tax-exempt investors from risk. Moreover, the level of risk permissible for tax-exempt organizations is already addressed by various other laws at both the Federal and State level. These laws permit the prudent use of debt financing.

As more fully described in my written testimony, an additional problem with the debt-financed income rules is that they have been applied in a rigid manner that makes formalistic distinctions between debt and leverage. The result is that the rule taxes transactions which involve direct borrowing in a traditional sense, while permitting investors to use leverage in more sophisticated transactions to escape tax.

Additionally, blocker entities are not the only way to avoid the debt-financed income rules. The rules can also be avoided by investing in mutual funds, REITs, segregated asset accounts, and through certain contractual arrangements.

I urge Congress to significantly restrict the application of the debt-financed income rules. Under current law, there is an exception for real estate transactions that meets certain anti-abuse requirements. The exception is currently available only to pension funds and universities.

This exception, and its anti-abuse requirements, should be used as a model for a broader exception, applicable to all types of debt-financed property and available to all tax-exempt organizations. My written testimony expands on this suggestion.

If Congress amends the unrelated debt-financed income rules as suggested, tax-exempt investors would no longer be forced to use blocker entities to avoid the debt-financed income rules on legitimate investments. Further, the current disparate treatment between direct borrowing and leverage and between different types of tax-exempt investors would be eliminated.

Thank you again for inviting me to testify. I would be pleased to respond to your questions.

The CHAIRMAN. Thank you, Ms. McDowell, for that very crisp, organized statement. Thank you very much.

[The prepared statement of Ms. McDowell appears in the appendix.]

The CHAIRMAN. Mr. Shapiro?

STATEMENT OF DANIEL S. SHAPIRO, PARTNER, SHULTE, ROTH, AND ZABEL, LONDON, ENGLAND

Mr. SHAPIRO. Chairman Baucus, Ranking Member Grassley, and members of the committee, my name is Daniel Shapiro. I am a founding partner of the New York City law firm of Shulte, Roth, and Zabel, and I am resident now in the firm's London office. I have provided tax advice to private investment funds for over 30 years. I appear today on behalf of the Managed Funds Association, whose members include professionals in hedge funds, funds of funds, and managed futures funds.

In accordance with this committee's requests, MFA has prepared a statement for the record, and my summary remarks today focus principally on why U.S.-based hedge fund managers establish foreign funds outside the United States, why U.S. tax-exempt organizations invest in those foreign hedge funds, as has been referred to, and the practice of U.S. hedge fund managers to defer the receipt of a portion of fees owed to them by foreign funds.

Hedge funds sponsored by U.S.-based managers, which have grown tremendously, as you know, play an important role in the U.S. capital markets and make positive contributions to the U.S. economy. The ability of U.S. managers to compete globally for talented personnel, for investment opportunities, and for investors is influenced by many factors, including the U.S. tax system. Any adverse changes in the tax rules applicable to U.S. managers could impact on the competitive advantage of the United States as a favorable jurisdiction for management of international hedge funds.

Hedge funds are structured in accordance with established principles of Federal tax law, and the structures promote key congressional and tax economic policies. This includes funds that U.S.-based managers establish outside the U.S. in order to compete with non-U.S. managers for passive investors all over the world. For more than 40 years, Congress has structured the tax code to encourage passive foreign investments in the U.S. by non-U.S. investors.

Among other things, Congress has exempted most forms of interest payments made to foreign investors from U.S. withholding tax. Likewise, it has generally exempted their capital gains from U.S. tax. Despite this advantageous treatment, for a variety of reasons, rather than investing as partners in U.S.-based hedge funds, most foreign investors strongly prefer to use foreign corporate hedge funds as the vehicle for the U.S. hedge fund investments. U.S. hedge fund managers would be competitively disadvantaged if they did not offer such foreign corporate structures to foreign investors.

Pension funds, endowments, and certain other tax-exempt organizations frequently, as has been mentioned, invest in hedge funds sponsored by U.S. managers. They make their hedge fund investments into foreign hedge funds to avoid the application to their investments of the technical unrelated business income provisions, the UBIT provisions, that have been referred to.

By investing in a foreign corporate hedge fund and not a tax-transparent U.S. partnership, a tax-exempt organization is not deemed to be using debt financing because the leverage does not pass through the foreign corporation. The conclusion that investment in foreign corporate funds by U.S. tax-exempt organizations does not trigger the UBIT rules has been specifically confirmed by a number of recent IRS rulings and implicitly by this Congress in connection with 1996 legislation.

From a tax policy standpoint, there appears to be little basis for imposing UBIT on passive investment income received by tax-exempt organizations where it has no liability for the leverage, has no control over the investments, or the extent of the use of leverage.

In that light, MFA welcomes a recent bill, H.R. 3501, which would amend the UBIT provisions relating to debt-financed income and would be intended to eliminate the need for U.S. tax-exempt organizations to structure their hedge fund investments as investments in foreign funds. That bill, MFA believes, to achieve its objective, needs to have certain amendments, and the MFA would be pleased to work with this committee and the Ways and Means Committee on necessary amendments.

Some U.S. managers elect to defer the receipt of a portion of the fees they receive from the offshore funds they manage. Foreign investors frequently expect these deferral elections to be made as the resulting deferrals buttress the alignment of interests between the manager and the investor in that fund.

However, onerous tax rules applicable to a U.S. taxpayer investing in a foreign fund, called the passive foreign investment company rules, effectively prevent a U.S. manager from investing directly in their foreign funds. Deferral of fees by U.S. managers which allows those fees to continue to be invested alongside their foreign investors and the earnings thereon are taxed in the U.S. at a top tax rate of 35 percent today when they are received at the end of the deferral period. The deferred amounts that remain as general assets of the foreign fund are subject to risk of loss if the fund becomes insolvent and cannot pay its creditors.

As to these deferrals, the manager is simply an unsecured creditor of the fund, and in this sense these deferrals are very different from traditional pension plans, 401(k), and tax-qualified arrangements. Moreover, they are subject to the same comprehensive tax regulatory regime enacted by this Congress in 2004 to govern all deferred compensation. These deferral arrangements also facilitate the ability of U.S.-based managers to establish deferred compensation plans for their employees, enabling them to compete for talented personnel.

Thank you very much for letting me testify.

The CHAIRMAN. Thank you, Mr. Shapiro.

[The prepared statement of Mr. Shapiro appears in the appendix.]

The CHAIRMAN. Dr. Gravelle?

STATEMENT OF DR. JANE G. GRAVELLE, SENIOR SPECIALIST IN ECONOMIC POLICY, GOVERNMENT AND FINANCE DIVISION, CONGRESSIONAL RESEARCH SERVICE, WASHINGTON, DC

Dr. GRAVELLE. Thank you for the invitation to discuss investments of educational institution endowments and offshore funds that avoid the Unrelated Business Income Tax.

Educational institution endowments totaled $340 billion in 2006 and earned a return of 15.3 percent, $52 billion in tax-exempt earnings. They are not evenly distributed. Harvard, the largest, had 8.5 percent, the top 5 schools had 25 percent, the 62 with over a billion dollars each had two-thirds.

Educational institution endowments have a significant and growing share of the portfolio in hedge funds and private equities. Twenty-two percent were in these hedge funds and private equity investments in 2006, up from 14 percent in 2002. The share would be much larger if weighted by endowment size, and funds over a billion dollars have over 28 percent of their portfolios in these investments.

It is very difficult to obtain data on individual institutions, but of the top 10 funds, Columbia University had a 45-percent share, while Princeton and Yale had 38 percent and 37 percent, respectively. Data on the share offshore are not available, but one study indicated that Duke University had 75 percent of their hedge funds in offshore investments.

Two possible revisions are to prevent tax-exempt educational institutions from avoiding the UBIT by investing in offshore funds, or to leave the current treatment of these institutions' investments in place, but address whether these institutions should be doing more, or be required to do more, to pursue objectives for the public good, such as making education more affordable.

Indeed, when questioned by a reporter about the use of offshore entities, a spokesman for Duke University stressed the use of endowments for financial aid and research. Yet, most of the return is being used to increase the endowment rather than being spent.

While the return was 15.3 percent, the payout rate was only 4.6 percent. Harvard, Yale, and Stanford earned returns of around 20 percent, but paid out 4.5 percent. Over 2 years, Harvard's endowment grew by 30 percent, while Yale's and Stanford's grew by 40 percent.

Institutions indicate that they limit payout rates, in part, to cushion shocks. However, despite a recession with significant market losses, average returns over the last few years, averaged over the years, were well above payout rates.

Many institutions have very high endowments per student. Per undergraduate, Harvard, Yale, and Princeton have between $2 and $3 million per student; for total students, including graduates, $1 to $2 million.

Of the 10 liberal arts colleges with the largest endowments, 7 of the 10 had over $500,000 per student. While endowments are growing, institutions with large endowments continue to raise tuition. If Harvard, Yale, Princeton, MIT, or Stanford had paid out one-tenth of one percent of their endowment for undergraduate tuition, undergraduate tuition increases would have been unnecessary. Of the 62 institutions with over $1 billion of endowments, their 6.8-percent tuition increase averaged only nine-tenths of 1 percent of the endowment.

Harvard's institutional undergraduate aid was less than one-half of 1 percent of the endowment, so that by paying out an additional one-half of 1 percent they could have doubled aid. The same is true of Stanford and Princeton, while Yale's undergraduate aid was even less, only one-third of 1 percent of the endowment. Many other schools in the top 20, and many of the 4-year liberal arts colleagues could have significantly increased their undergraduate aid with a small additional payout, while still permitting endowment growth.

Alternative options to restriction of these offshore investments by educational institutions might include a payout rate similar to that of private foundations. The actual payout rate is required to be 5 percent, and the average is 7 percent, well above the rates of these educational endowments.

There could also be a payout rate required for universities and institutions with large endowments per student, or the payout rate could be related to return to allow some growth. Another option, if the public policy concern is about affordable education, would be to impose a tax on the endowment for schools with tuition increases over a pre-determined threshold. These are not recommendations to you, they are just ideas of different ways to look at this issue.

Thank you.

The CHAIRMAN. Thank you very much, Dr. Gravelle.

[The prepared statement of Dr. Gravelle appears in the appendix.]

The CHAIRMAN. Ms. Munson?

STATEMENT OF LYNNE MUNSON, ADJUNCT FELLOW, CENTER FOR COLLEGE AFFORDABILITY AND PRODUCTIVITY, WASHINGTON, DC

Ms. MUNSON. Chairman Baucus, Ranking Member Grassley, and members of the committee, thank you for inviting me to testify on the topic of higher education endowments.

I am an adjunct fellow with the Center for College Affordability and Productivity. I am also the mother of a 1-year-old, whose higher education will cost a half million dollars if current tuition trends continue.

Senators, our colleges and universities are sitting on some of the largest fortunes amassed by any institutions in the history of our Nation. These riches are proof of America's economic strength and of the boundless generosity of its citizens. But I am afraid to report that, in too many cases, this wealth is being hoarded instead of shared.

College and university endowment spending practices are stuck in a past when endowments were small, investment gains were marginal, and economic rainy days were frequent. Today, higher education endowments are massive and, as we have been hearing, aggressively invested. Yet, payouts are miserly. This begs the question, is the public benefitting enough? Research indicates the answer is no.

Dr. Gravelle points out that endowment wealth is concentrated in the upper ranks, much of it at 62 institutions with endowments larger than a billion dollars, but just 3 years ago only 39 schools had endowments larger than a billion. That is a 38 percent increase in 3 years.

This wealth no longer resides solely, or even primarily, in the New England corridor. Twenty-six States boast institutions with billion-plus endowments. The University of Pittsburgh, Purdue, Michigan State, and little, 1,500-student Grinnell College each have endowments larger than a billion dollars. A third of billion-plus endowments are at public institutions.

Now, some of the most out-sized endowments are at elite institutions, as Dr. Gravelle mentioned: Yale has $2.8 million in the bank per undergraduate. But all private schools with endowments larger than a billion have, on average, $430,000 in their endowment per student, and plenty of public schools also have impressive endowment-to-student ratios, including the University of Virginia, which banks $320,000 per undergraduate.

What the data show is that endowment wealth is everywhere, except in the hands of the students who need it today. Last year, endowments increased 17.7 percent, on average. Yet, despite double-digit increases going back a decade or more, endowment spending is at a nearly all-time low of 4.2 percent, down from 5.1 percent in 1994 and 6.5 percent in 1982.

Now, schools often blame low payouts on donor restrictions, but 45 percent of endowment funds at private institutions are unrestricted, as are 20 percent at public institutions. Financial aid is the number-one restriction designated by donors. In 2005, donors restricted 36 percent of their gifts for financial aid, yet actual spending on financial aid is shamefully small, with many schools putting just a fraction of a percent of endowment value toward aid.

Meanwhile, tuition has been going up so rapidly for so long it has reached nearly ungraspable heights, so let me put today's tuition costs in concrete terms. Senators, what would your constituents say if gasoline cost $9.15 a gallon, or if a gallon of milk cost $15? That is how much those items would cost today if their price had gone up at the same rate as tuition has since 1980.

Our colleges and universities need to be reminded that they are education institutions, first and foremost, and that that is why they receive the tremendous tax breaks that they do. Their practices, including their handling of endowment monies, should reflect their priorities as educators. Payout information and other basic higher education endowment statistics must be brought out of hiding. Should this sunshine prove insufficient motivation, Congress should not hesitate to consider a minimum payout requirement, and 5 percent should be a starting point.

Many schools have been rolling over so much money for so long, that they should easily be able to accommodate a higher rate of payout. Possibly the most significant challenge to policymakers will be to make sure that any newly directed monies actually go toward aid or tuition reduction and do not become part of an elaborate shell game.

Thank you again for inviting me to testify. I would be happy to answer any questions I can.

The CHAIRMAN. Thank you, Ms. Munson, very much.

[The prepared statement of Ms. Munson appears in the appendix.]

The CHAIRMAN. I am going to start with you, Mr. Berkley and Mr. Kramer, and try to sharpen and/or resolve the difference between the two of you and try to figure out what is going on here.

Mr. Berkley basically says, Mr. Kramer, that insurance companies which incorporate in the United States and reinsure offshore, say in Bermuda, have a very significant competitive disadvantage compared with Bermuda reinsurance companies based in Bermuda, which then use their subsidiary, say, in the United States to write the policies. The net effect of all that is, the policies written in the second situation, the premiums can be lower, and it is just a big competitive disadvantage, unfair disadvantage, to the standard model.

When these laws were set up years ago, the tax laws, it presumed that there would not be a big shift offshore. That is, the reinsurance company domiciled in offshore countries like Bermuda would then take advantage of current tax laws to get a benefit. I mean, it sounds pretty compelling, what Mr. Berkley is saying. What is the response? It sounds like your company is at a big competitive advantage compared with those that incorporate in the United States and reinsure offshore.

Mr. KRAMER. If I may, Senator, thank you. There are two issues. The first, within the U.S. tax law there are two broad issues. One is the excise tax that Bermuda companies pay, and that is a 1 percent on gross. Insurance companies are not always profitable, but the gross tax is always paid. So, for example, in years 2004 and 2005, reinsurance ceded to Bermuda incurred a 1 percent gross tax, whereas the losses that the U.S. companies sustained were tax offset against their payments.

The CHAIRMAN. Is there a deduction, though, when the subsidiary to the U.S. cedes to the reinsurer? Is there not a deduction in addition?

Mr. KRAMER. When the U.S. company cedes to a Bermuda company, it recaptures the expenses and it cedes premium. When the losses are paid, they are returned to the insurance carrier and there is no tax offset, so there is no tax carry-back, carry-forward, or tax offset. That is what I said earlier, that there was not one penny of tax offset in the $24 billion of claims. The 1 percent gross tax is whether it is profitable or unprofitable, so there are years like 2004 and 2005 when the effective tax, the 1-percent excise tax, was actually greater than the 100-percent tax rate. That is the first thing.

The second thing is, insurance companies, when they reinsure, it is really an adversarial transaction. It is a transaction between a knowledgeable buyer and knowledgeable seller, with the buyer trying to get the best possible price and the seller trying to get a premium at lower than his lost costs.

The transfer pricing rules ensure that that type of adversarial transaction is the terms on which risk is transferred. And it is not a free lunch, as I said.

The CHAIRMAN. I want to give Mr. Berkley a chance to respond. My time is starting to expire.

Mr. KRAMER. I am sorry.

The CHAIRMAN. Mr. Berkley, what about all that?

Mr. BERKLEY. Well, first of all, no one in the insurance business is in the business because they want to make 1 percent, so the excise tax is great, but, even if you were to raise the excise tax, you could not raise it enough.

Number two, transfer pricing does not really work. First of all, you can write a reinsurance contract, and the timing of when people pay losses has a lot to do with the profitability of insurance. So if you write a reinsurance contract that is perfectly fair as to sharing of the losses, but you pay the last losses instead of the first losses, the reinsurance company could make a lot of money.

In addition to that, the nature of taxation for insurance companies is unique. You pay based on the volume of business and the losses that are incurred, so, if you reinsure a large percentage of your volume of business offshore, you effectively avoid the nature of the discounted prepaid tax that insurance companies have been paying since 1986. So it does not work.

The CHAIRMAN. And it is your view that the consequences of the current tax law and the way it is being utilized by, say, offshore reinsurance companies, is that, what, a lot of U.S. insurance is not going offshore?

Mr. BERKLEY. Effectively, the nature of the law is, the more you reinsure offshore the more you avoid paying taxes, and that is really the problem. So, therefore, they have a substantial competitive advantage in writing direct business and reinsuring to affiliates.

The CHAIRMAN. All right. Well, my next questions are on another subject and I only have 10 seconds left, so I will now turn to Senator Grassley.

Senator GRASSLEY. Mr. Berkley, in seeking to level the playing field, your coalition has not sought tax relief. Instead, you have focused on changing the tax treatment of foreign-based competitors. A low-tax jurisdiction is economically beneficial when we are talking about income, but not when we are talking about deductions or losses.

So these questions. I will ask them all at once. What tax benefits are available to domestic insurers that are not available to the extent risk is transferred offshore? Why are those foregone benefits outweighed by the tax benefits of earning investment income offshore? And if you took the other approach, that is, asking for tax relief, what would you ask for?

Mr. BERKLEY. I do not believe there are any benefits that we get—as long as we are profitable, which is obviously the reason we are in business—that our foreign competitors do not. And they do have the flexibility of leaving business here if the business proves to be not profitable, so they can generate their losses here if they time it right. If I were to be blunt, what I would have to ask is that we pay no taxes.

The same problem exists in the U.K. In fact, the U.K. participants are going to the legislature in the U.K. and suggesting, since all of the Lloyd's participants have been moving to Bermuda, that the U.K. insurance participants should pay no taxes. I would be more than happy if you would grant us that. [Laughter.]

Senator GRASSLEY. All right.

Mr. BERKLEY. As would my entire coalition.

Senator GRASSLEY. All right.

And then I would ask you also, Mr. Berkley, your efforts have principally focused on Bermuda, but European insurers and reinsurers have had a significant presence in the United States for many years. Are your competitiveness concerns equally applicable to competitors like U.K., Germany, and Switzerland, or any other country, and why or why not?

Mr. BERKLEY. Well, in fact, the major participants at Lloyd's have effectively redomesticated in Bermuda, so their U.S. businesses now will be going at the end of the road to Bermuda. Swiss Re, which is one of the largest competitors, has moved its capital base to a more favorable tax environment, and Switzerland was favorable already.

So all of these other countries have more flexibility in their tax laws than we have, so we are concerned with, in fact, all other areas. So we would suggest that we would need to do something for all affiliated reinsurance transactions outside of the U.S. Yes, sir.

Senator GRASSLEY. All right.

Mr. Kramer and Mr. Berkley, the offshore reinsurance issue that we are examining today has to do, of course, with just property and casualty. That is all we have talked about. What makes this issue so unique to the property and casualty insurance company as opposed to, for instance, life insurance? Are there other types of insurance that are commonly reinsured with affiliates?

Mr. BERKLEY. The property and casualty business and financial guaranty business have a unique set of rules and taxes where we effectively prepay taxes based on the volume of business, based on investment income. Life insurance has its own set of taxes and is not impacted by these differentials.

Mr. KRAMER. If I may.

Senator GRASSLEY. Yes.

Mr. KRAMER. The property and casualty business is highly volatile, unlike the life insurance business, which is quite predictable. It is this high volatility that leads to the need for business reinsuring extensively, because individual companies cannot take that level of volatility without running afoul of capital requirements within their State jurisdictions.

So the cession of business to Bermuda for this high volatility is clearly Bermuda's specialty. Bermuda has a relatively small working force infrastructure. It has 1,700 people in our association working in Bermuda, but the island cannot sustain much more, nor can it compete in any of the areas that Mr. Berkley's companies compete in. So, volatility is one issue.

I go back again to the excise tax, which only Bermuda pays and not the other reinsurance jurisdictions, and that makes an offset to U.S. carriers which do have tax advantages on dividends, tax advantages on municipal bonds that are not available to foreign companies. A 1-percent differential does, in fact, overcome those differences and, in fact, levels the playing field. The last thing is, Bermuda paid their claims. They paid every claim in their Hurricane Katrina claims, paid straight out without argument about conditions, terms, et cetera. This was a wholesale transaction and those claims were fully paid.

The CHAIRMAN. Thank you very much, Senator.

Senator Lott?

Senator LOTT. Thank you, Mr. Chairman. Thank you to all the panel for being here and for your very helpful testimony. But I am going to direct most of my questions to Mr. Berkley and Mr. Kramer.

I would like to begin, Mr. Chairman, by asking that my prepared statement be included in the record, as well as a devastating article from *Bloomberg* entitled, “Home Insurers’ Secret Tactics Cheat Fire Victims, Hike Profits.”

The CHAIRMAN. Without objection.

[The prepared statement of Senator Lott appears in the appendix.]

[The article appears in the appendix on p. 101.]

Senator LOTT. Now, Mr. Chairman, having said that, some of the things you say there really caught my attention. Let me acknowledge up front a disclaimer. I am from the Gulf Coast of Mississippi. I am a victim of Katrina. Some best friends, the people I love most in the world, have all endured the indignities that we have had to go through in the effort to recover. I have been devastated by the insensitivity, unfairness, and greed of the property and casualty insurance industry. It has been astounding to me.

What really makes it embarrassing, is I came from a background of being an insurance defense lawyer for one of the companies, in fact, the company that has been the worst.

I have a 34-year record—actually, 36 years now—of being supportive of business, fairness, and opportunities and making a profit. I understand. You are not in business as a charity. You are in business, Mr. Berkley, to make a profit. But I submit that in corporate America, in instance after instance, the focus has come just on profitability and you have lost sight of one other thing you provide, and that is, you are providing a service.

When you receive premiums, you make a commitment to cover certain things. When you do not do that, or delay that, I think you are headed for real trouble. I have been astounded by what I found out about property and casualty. You are not covered by antitrust laws, and I believe that the industry uses the tax code to delay paying premiums, or to not pay them at all. Therefore, I have real problems with a number of things in the tax code.

Now, we all want fairness in the tax code. We want to know what the effect of that fairness is to the availability of customers, and that comes to what Mr. Kramer was saying. See, I am a little bit worried. We want fairness. If there is some advantage in the tax code that should not be there, if we take it away, what is going to be the impact on the availability of insurance to people?

In my area already, we cannot get coverage for houses and businesses. So, I am cautious and a little concerned about how we deal with this reinsurance question. But I do think we have to pursue responsible business practices.

Now, having said that, I want us to look at that. What would be the effect? I think, Mr. Berkley, you would say that, if we did what you proposed with regard to these offshore reinsurers, that it would not affect adversely the policyholders who are already not being treated fairly. So that was a loaded question. I intended it that way. But I want to give you a chance to respond to at least that, if not all the other things I had to say.

Mr. BERKLEY. Well, first, I would respond and say that every claim we had in Mississippi was paid in full in 90 days.

Senator LOTT. Not mine.

Mr. BERKLEY. Every claim we had.

Senator LOTT. Your company. All right.

Mr. BERKLEY. Number two, the third day after Katrina we were in Mississippi with satellite telephones that we gave to every agent we had so they had communication. Every single agent we had was offered at no charge, no nothing, here is a satellite phone, here is a solar charger, you have a way to connect. No charge, no question, call anybody you want, we paid the bill. We think that that societal response is an important part. And, yes, it is true, some people did not do a perfect job, but a lot of people tried to do a good job in spite of the fact that some did not do a good job.

Senator LOTT. You do represent Liberty Mutual and Hartford?

Mr. BERKLEY. No. Liberty Mutual and Hartford are in the coalition. I am talking about our company, which is located in Meridian. I might add, it took us 87 days to get a license in Mississippi and we did not have to go to Bermuda to get a license. George Dale got us through in 87 days.

But the fact is, there is plenty of capacity. But Bermuda, where you pay no taxes, is a better place to put your capital. So it was basically United States dollars that went to Bermuda, and they went to Bermuda because they could invest there at a better return. They would have invested here if that was the alternative.

Senator LOTT. How do you react, Mr. Kramer?

Mr. KRAMER. Well, it is distressing that the performance of the insurance industry was not satisfactory. The reinsurance industry is contracts between professionals, and those claims get paid very quickly. As I said, we paid our claims straightaway. In fact, in the World Trade Center, both ACE and XL paid their claims straightaway and had no litigation, while there was much litigation against other insurers and reinsurers. And so it is capacity we provide to the market in this specialty area that the primary companies are loathe to write. Some of your largest American companies are canceling policies in your jurisdiction and in Florida.

Senator LOTT. Yes.

Mr. KRAMER. And yet, we supplied reinsurance coverage to make the capacity available to them. So, Bermuda is a specialty market that focuses on this kind of high risk. It is a wholesale transaction, reinsurance between companies. We pay claims because it is contractual, and very quickly.

Senator LOTT. Mr. Chairman, I could go on at length, but my time has expired. Maybe I can get a second round.

The CHAIRMAN. Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman.

Mr. Berkley, you noted in your testimony that U.S. subsidiaries of foreign insurance companies granted more than $32 billion in premiums to their foreign parent in 2006 in return for reinsurance contracts, and that over half of those foreign parents are based in Bermuda where there is no tax on investment income. In 1996, the comparable figure was $4 billion, approximately.

What is the average tax rate of Bermuda-based insurers compared to their U.S. competitors in the property and casualty business, and what is likely to happen to the U.S. property and casualty business if this trend continues?

Mr. BERKLEY. Currently, I do not believe Bermuda charges a tax on property and casualty income. Ultimately, in order to compete, the U.S.-domiciled companies will have to find a way to equalize that tax advantage somehow or another.

Senator BUNNING. What is your tax rate?

Mr. BERKLEY. We pay a full 35-percent tax rate.

Senator BUNNING. And it is my understanding that the Bermuda tax rates, if they include those domiciled in the U.S., it is anywhere from 3 to 18 percent.

Mr. BERKLEY. That is correct, sir.

Senator BUNNING. That is correct. Thank you very much.

Mr. Kramer, I understand that your company is about to acquire Valiant Insurance Company, a U.S.-based property and casualty insurer licensed in 47 States. Can you explain for us the economics of this acquisition? How many employees will be based in Bermuda? Will customers notice any difference in how the business is run? Do you anticipate that Valiant will increase the size of its reinsure contracts or keep them roughly the same?

Mr. KRAMER. Well, sir, first, the purpose of acquiring Valiant is to build diversification within our portfolio. To date, we specialize in Bermuda in reinsurance, and principally catastrophe reinsurance. In order to balance our book and create greater stability, we are trying to build operations that have diversified income, so we have acquired a syndicate at Lloyd's where we write business across a——

Senator BUNNING. How many employees will be in Bermuda?

Mr. KRAMER. There are currently 53 employees in Bermuda.

Senator BUNNING. From this Valiant Company?

Mr. KRAMER. No. From Valiant——

Senator BUNNING. How many will be moved from Valiant?

Mr. KRAMER. None.

Senator BUNNING. None.

Mr. KRAMER. Quite the contrary.

Senator BUNNING. Quite the contrary.

Mr. KRAMER. We are hiring in the United States.

Senator BUNNING. Will your customers notice any difference in the operation of Valiant?

Mr. KRAMER. Valiant is essentially a relatively inactive company and we are activating it, so we are hiring staff now, acquiring space, and building operations and filing forms and claims to provide capacity in the U.S. market.

Senator BUNNING. Thank you. I have some more.

Ms. Munson and Dr. Gravelle, both of you illustrate in your testimony that our colleges and universities have enjoyed extraordinary rates of return on their investments, but they appear to be operating less like public charities.

The aggregate size of university endowments has grown to $340 billion, according to your testimony. At the same time, endowment spending on education has declined to an all-time low, while tuition has skyrocketed. Do you believe a minimum payout requirement for universities with endowments of more than $1 billion would harm these institutions? Would not lowering tuition rates at elite institutions affect tuition rates throughout the system? Either.

Dr. GRAVELLE. I think that much of these institutions have so much endowment per student, that a small payout increase to 5 percent, or even more, would probably leave them in very good shape.

Senator BUNNING. What would that mean to the students, say, at Yale, Harvard, or Princeton, 5 percent of the payout?

Dr. GRAVELLE. If Harvard was paying 4.5 percent and they paid out 5 percent, then they could double their undergraduate aid to middle- and lower-income families. They could avoid tuition increases, I believe, for the next 5 years, undergraduate tuition increases.

Senator BUNNING. If the same rate of return that universities have experienced is continued for the next 20 years, then why are we allowing these endowments to be tax-free?

Dr. GRAVELLE. That is your question, not mine.

Senator BUNNING. All right.

Ms. MUNSON. That is a terribly good question.

Senator BUNNING. I have one question more for Mr. Shapiro. I apologize.

Ms. MUNSON. Just to speak to the issue of Harvard, they are currently spending between a quarter and a third of 1 percent of their endowment toward financial aid.

Senator BUNNING. Thank you.

Ms. MUNSON. If they were spending even 1 percent, I do not believe any undergraduate would have to pay a cent.

Senator BUNNING. Mr. Shapiro, the maximum amount an individual can contribute to an IRA is about $4,000 per year. How much income can the manager of an offshore hedge fund defer, and how are the deferred amounts taxed during the deferral period?

Mr. SHAPIRO. There is actually no specific limit on the amount that a manager can defer, obviously, up to 100 percent. Most managers do not defer that high a percentage.

Senator BUNNING. And what about tax?

Mr. SHAPIRO. Well, there is no tax on the accumulation of the earnings. When the money comes——

Senator BUNNING. Until?

Mr. SHAPIRO. Until it comes back to the manager, which is typically 10 years or less. It could be 3 years, 5 years, whatever the manager elects.

Senator BUNNING. Thank you.

The CHAIRMAN. Thank you, Senator.

Senator Hatch, you are next.

Senator HATCH. This hearing has been extremely interesting to me, and I have enjoyed it very much. I want to thank you all for your testimonies.

Mr. Berkley, I can see the problems you are illustrating. Do you have any particular, specific legislative fix in mind?

Mr. BERKLEY. We believe that there has to be some device to be focused at the reinsurance transaction from the affiliate to parent or offshore affiliate. So we would suggest that the deduction for affiliated reinsurance be eliminated if the reinsurance is more than the average amount. For example, the average amount for the industry is somewhere between 10 and 15 percent to external reinsurers on commercial lines business.

The average amount going offshore to affiliates is substantially more than double that amount. So if you were to eliminate the deductibility of that differential, that would, in fact, at least go part way towards solving that problem. It really goes to the heart of the issue of how taxation works on property and casualty companies, and that is, you are discounting the amount of loss reserve established, and loss reserves are established virtually on a tabular basis when they are established by line of business.

Senator HATCH. Well, thank you.

Mr. Kramer, thank you for presenting your side of the argument. Do you believe that current U.S. tax law bestows a competitive advantage on offshore reinsurance companies as compared with U.S.-based reinsurers, assuming that reinsurance is covering U.S. risks?

Mr. KRAMER. I genuinely believe, sir, that the U.S. tax law does adequately deal with it. A perfect example is, Senator Bunning mentioned $32 billion of offshore business ceded, and referred to a trend of growth. In fact, the 5-year trend may show growth, but the 1-year trend shows, in fact, a 20-percent decline. Why, in fact, would there be a 20-percent decline in offshore insurance ceded if, in fact, these tax advantages were so great?

I pointed out earlier that, in fact, inter-company cessions had done this in the reinsurance industry at all levels, and it is not just tax. But I do think excise tax, and the fact that we do have transfer pricing, adequately protects the U.S. industry and does, in fact, level the playing field, as Mr. Berkley mentioned.

Senator HATCH. All right. I am not sure I can accept your use of the term "protectionist tax measures."

Mr. KRAMER. Did I say "protectionist tax measures"? I am sorry, sir.

Senator HATCH. I thought you did. For the idea that the U.S. should consider changing the tax law to reduce the incentive to reinsure through a related non-U.S. company. In my mind, protectionist measures typically are put in place in relation to non-tax cost disadvantages possessed by a country's producers. Now, this seems to me to be a problem of a tilted playing field. Do you care to comment about that? And you wanted to say something, Mr. Berkley, on the prior question?

Mr. BERKLEY. I would say, the reason we had the one decline in reinsurance this past year was because there was a single large transaction with one company that inflated last year's and took down this year's. So other than that, the trend upward would have continued.

Senator HATCH. All right.

Mr. Kramer, on the question I just asked.

Mr. KRAMER. I am sorry, Senator. The question was?

Senator HATCH. Basically, I said that protectionist measures typically are put in place in relation to non-tax cost disadvantages possessed by a country's producer. This seems to me a problem of a tilted playing field, and I would like to get your view on that.

Mr. KRAMER. As I said, Bermuda has several advantages, and I recognize those. The first and foremost happens to be the regulatory environment. There is, without a doubt, some advantage that Bermuda has in that its taxes are done indirectly rather than directly, so it does not affect the reinsurance transactions. But the business is transferred with substantial risk, and that is the thing that is so difficult to communicate. In fact, the industry takes substantial risk and incurs substantial losses, and those losses are not tax offset either. So to the extent gains are made, Bermuda does not tax. When losses are incurred, there is no tax and no tax credit.

Senator HATCH. My time is up, Mr. Chairman. Thank you.

The CHAIRMAN. Senator Lincoln? Thank you, Senator.

Senator LINCOLN. Thank you, Mr. Chairman. A special thanks to you and Senator Grassley for bringing us together today again to learn so much more about a very complex, and yet very important, issue.

The discussions we have been having in the committee over the past several weeks regarding tax treatment of hedge funds and private equity firms has certainly been enlightening to me, and I do not profess to know everything I need to know yet, so we are delighted to have today's discussion, which I think is very useful, and I hope we will continue those.

But we certainly have an increasing number of markets that are being impacted by inequities in the code, which is what we have to deal with, whether it is the real estate market, investment advisement sectors, reinsurance market, or in my State, the timber market. The bottom line is, we are in a situation where there are a growing number of similarly situated enterprises doing the same work in the same way, but I guess being taxed at a dramatically different rate. That is what is causing so much, I guess, confusion and discord in terms of how we deal with that. So, hopefully we will take a closer look at the tax code.

America has certainly always been a glowing model of entrepreneurship, and we do not want to discourage that. We want to continue to roll up our sleeves, work hard, and do the absolute best that we can with the talents we have been given, and I hope that we can do that but still be fair in how we deal with the tax code.

Mr. Berkley, I know that the Chairman asked this question and I was not here yet. I apologize. Maybe you can expand a little bit on how you did answer his question, though, identifying that this is not a new issue, obviously, with the Clinton administration, the current administration, the problems that have been identified. We tried to fix it in the JOBS Act. I am just trying to make sure of your answer, and maybe you can expand on your answer there. That was not the appropriate fix? What was wrong with that fix that we tried to put in the JOBS Act?

Mr. BERKLEY. Well, most Bermuda companies have very low tax rates already, and they have been very successful in transferring their profits to Bermuda and lowering their tax rate. But that is in part because of the unique nature of the taxation for insurance companies, which is not measured purely by profit, but is a discount on the loss reserves, which is investment income. So the more you move over to Bermuda, regardless of the margin, the more you save on taxes.

So if you reinsure a disproportionately large amount to an affiliate, you, by the very nature of the unique tax code for this business, save on your taxes. So that does not appear. The transfer pricing issue will focus somewhat on underwriting profit, but even on that it is very, very hard for the Treasury to understand the complexities and the words in the contract because of timing of payments.

So if you write a quota share reinsurance agreement where you share pro rata, but the reinsurers pay the last half of the losses, they will make 5, 7, 10, 15 percent more margin than the other participants who pay the first share.

Senator LINCOLN. So you are saying that it is really the difficulty of the IRS in trying to determine their reach?

Mr. BERKLEY. On the underwriting piece, yes. But on the investment piece, which is the biggest piece, it is sheerly based on the volume, not based on a fair margin, because insurance companies are taxed on a discounted basis, sheerly on the volume of reserves. So the more you reinsure, the more you save on taxes.

So there are two pieces. The underwriting margin has to do with the complexity, and the aggregate saving on investment income has to do with the sheer volume of what you move overseas.

Senator LINCOLN. All right.

To the endowment question; I think that has been asked as well. Ms. Munson and Dr. Gravelle, my understanding is that many of our universities' endowments are comprised of funds that have specific—and limited or restricted—purposes (from the donors, particularly, I suppose). I am just kind of curious. You both have seemed to indicate that you could increase the mandatory endowment payout. Is that correct?

Ms. MUNSON. Yes. The fact of the matter is that 45 percent of funds at private institutions are unrestricted, as are 20 percent of funds at public institutions. Donors actually choose financial aid as their number-one restriction of choice. Thirty-six percent of donations in 2005 were earmarked by donors specifically for financial aid. It is their favorite category, far above research, far above faculty salaries, libraries, and all the rest. So there really are ample funds there, even though donors do aggressively restrict their funds at times. This is the category that they believe in.

The CHAIRMAN. Thank you.

Ms. MUNSON. I believe there are donor intent issues, actually, that could be investigated.

Senator LINCOLN. So there would not be a conflict there then in terms of——

The CHAIRMAN. Thank you, Senator, very much.

Senator Wyden, you are next.

Senator WYDEN. Thank you, Mr. Chairman. Thank you for holding these hearings, because we are learning an awful lot as we go. It seems to me—this has been a very good panel once again—we are looking at upside-down tax policy. The hearing today highlights two examples of how the current tax code creates a lose-lose situation for U.S. businesses and the U.S. Treasury by giving foreign companies a tax advantage over American companies. That is what we have been examining in the reinsurance area and for tax-exempts that are investing, our tax-exempts, in hedge funds.

So my question for you, Dr. Gravelle, given these distorted policies that address the questions of the American investment, can you suggest ways to reform the tax code so it encourages U.S. businesses to invest in our country, or at least put our businesses on a level playing field with foreign competitors?

Dr. GRAVELLE. Well, Senator, I think in your own tax reform legislation you have been considering the issue of ending deferral or expanding the reach of subpart F. That is certainly something that you could do and use the revenue, if you wanted to, to lower the corporate tax rate.

There are other proposals. The proposals that would target tax havens. As Senator Dorgan's chart over here, when we looked at foreign tax issues we found the earnings of subsidiaries of U.S. multinationals were 4 times the Cayman Islands' GDP, so there is a lot of shifting of profits there. So you could target something there.

We not only defer taxes, but we allow parent companies' interest deduction to be taken even though the income is not being taxed. The Advisory Panel suggested cutting back on that. So there are lots of ways, sort of, to not increase the total tax burden on U.S. businesses, but to shift it so that investing in the United States becomes more attractive than investing abroad.

Senator WYDEN. One of the reasons that I have advanced this Fair Flat Tax proposal over the last couple of years is to get out some of these distortions as they relate to American investment. I know you cannot get involved in supporting some piece of legislation or opposing it, but just from the standpoint of economic analysis, economic sense, would it not be desirable for our country to have a significantly simpler tax code that did not allow, and in fact end up encouraging, investors to play all these shell games to avoid tax liability?

Dr. GRAVELLE. Well, I think that most economists would say, for economic efficiency you want a broader base. You want equal tax rates on different kinds of investments, whether it is by industry, or abroad, or in the United States. There are many tax expenditures right now that we have that could be changed to broaden that base and make them a neutral tax system.

Senator WYDEN. I probably ought to quit while I am ahead. Does any other panel member want to take issue with the ever-thoughtful Dr. Gravelle? [No response.] Then I will put you all down as supporting the Fair Flat Tax. [Laughter.] And seriously, we are interested in working with all of you in the days ahead. I think what has been so valuable about Chairman Baucus's hearings is that we have been learning as we go. I will tell you, I listen to all of the experts, and some predict that these proposals will have no effect. Others say that these proposals will end up causing great damage to our country, practically be the end of western civilization.

What I am certain of, if these proposals pass, it will be a matter of hours until the lawyers and accountants go out and try to invent scores more loopholes to get at exactly what Dr. Gravelle is talking about. So from my little lonely outpost here on the Senate Finance Committee, I am going to keep prosecuting the case for the Fair Flat Tax. I thank you all for your expertise and will want to work with you in the days ahead.

Again, a big thanks to you, Mr. Chairman, for giving us a chance.

The CHAIRMAN. Thanks, Senator, very much. You bet.

Senator Roberts?

Senator ROBERTS. Senator Wyden, are you for the fair tax or are you for a national consumption tax?

Senator WYDEN. The fair flat tax. What Ronald Reagan was for. [Laughter.]

Senator ROBERTS. Well, there he goes again. [Laughter.] Did you come up with a number in regards to what that percentage would be?

Senator WYDEN. I do not want to——

Senator ROBERTS. And I appreciate you being part of the panel.

Senator WYDEN. I do not want to take from your time. My proposal starts with the exact rates that Ronald Reagan proposed in 1986, and of course I want to work with colleagues in a bipartisan way.

Senator ROBERTS. What percent was that?

Senator WYDEN. Ronald Reagan initially proposed 15, 25 and 35. They ended up between 14 and 28. I am certainly negotiable on the concept. What he did was, he cleaned out the clutter, held down rates, and kept some progressivity. Virtually everybody who has come before the Senate Finance Committee says that those principles—while the rates we would use are debatable—are still valid today.

Senator ROBERTS. Does "clutter" include home mortgages and charitable giving——

Senator WYDEN. I do not touch those at all.

Senator ROBERTS [continuing]. And the expensing of agricultural expenses in Oregon?

Senator WYDEN. Mortgage, charity, those things that are so important for people——

Senator ROBERTS. That is not clutter?

Senator WYDEN. That is not clutter. Thank you.

Senator ROBERTS. All right. Thank you.

Senator WYDEN. And agriculture, I am for, too.

Senator ROBERTS. Thank you, Dr. Wyden. [Laughter.]

I am interested in the testimony about the college endowments. This is a repeat of Senator Lincoln's question. And I apologize for being repetitive, but I am a slower learner. Ms. Munson and Dr. Gravelle, I have a couple I would like to ask. I think both of you have suggested that 5 percent could be a starting point for a payout requirement, consistent with that required of private foundations. Dr. Gravelle, you have also suggested an option that would cap the requirement distribution so that it would not exceed the earnings from the endowment.

I guess my question is—and we went through that with Senator Lincoln when she said an endowment is usually comprised of thousands of donations that are often restricted for certain purposes. These restricted donations, in perpetuity, are important to funding scholarships, attracting and retaining top-flight professors, and promoting cutting-edge research.

So I guess my question is, if such a cap were in place—and I think you have already answered this to some degree, but if you would like to add to it, that is the intent of my question—would it be sufficient to ensure the adequate growth of the endowment and maintain the purchasing power of the initial donation?

Say that I gave $100,000 to the home of the ever-optimistic and fighting Wildcats at Kansas State University, and that is in perpetuity. That value has to stay the same. And with inflation in the next 20 years, who knows? If past history is any example, it could be considerably more than that. So I guess my question is, can we ensure the adequate growth of the endowment so that it maintains that purchasing power? Either one. Either one.

Dr. GRAVELLE. I guess I will go first.

Senator ROBERTS. And my wife says hello to you, Ms. Munson.

Dr. GRAVELLE. The return right now is so far above the payout ratio, that it is hard to imagine. One could always go back and revisit it if returns fell through the roof, but these institutions have the ability to invest in extremely high-yield returns because of their size, and they are so far above payout ratios, they are growing much faster. They are not just keeping up with inflation, they are growing much faster than real growth.

They are not being spent to attract professors either, because they are not being spent. They are just being retained. So when you have a 15-percent return, and that is just average, and a 4.5-percent payout ratio, you have 10 percentage points plus of difference, and that is way above inflation or real growth.

Senator ROBERTS. Ms. Munson?

Ms. MUNSON. With regard to the 5 percent number, Senator, back in 1968 the Ford Foundation published an important report called "Managing Education Endowments," and they recommended 5-percent payouts from higher education endowments. At the time, those endowments were earning just 6.7 percent annually. Now it is 17.7 percent. That does include new donations to the endowment, but that is only 3 percent, though. So that is why we are talking about 14 percent as the amount of increase in the last year, and it has been in the double digits for a very long time.

So there have been so many years of accumulated and reinvested wealth, it is really hard to imagine how a 5-percent payout requirement could possibly harm the value of these endowments. That is why I say I think it should be a starting point, and there are many who believe that 5 percent is too low of a payout requirement for private foundations and they are, after all, choosing to spend out 7 percent, on average, these days.

Senator ROBERTS. Well, I want to thank all the members of the panel for taking their time out for the testimony. My time has expired.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

I would like to ask a question of you, Mr. Shapiro, basically with respect to deferred compensation. It is my general sense that, although there is no legal limit for unqualified deferred compensation, which means that an executive could defer all of his or her compensation if he or she wanted to, that there is still some tension between the executive of, say, an American corporation and the corporation itself as to whether or not the compensation is deferred. The longer it is not deferred, the more a corporate deduction is denied, and so forth.

Contrast that with offshore deferred compensation, where the fund manager not only manages the funds, but also manages the deferral. He or she, the manager, makes both choices. With respect to the offshore compensation, it is my understanding that the fund manager manages the offshore fund, say, and derives fees.

I will put aside for the moment whether it is management fees or carried interest. Those fees can be deferred indefinitely by the fund manager and put back into the fund to earn a certain rate of return, or can be transferred to a bank account, say, in the U.S., but it is paid out by a Cayman Island's corporation, which in effect still insulates that payment. Even though it is paid in the U.S., it is still deferred indefinitely. But in that second case, there is no tension, really, between payor and the payee, whereas there is tension in the first instance, the U.S. corporation.

So the real question is, who is getting disadvantaged, if anyone, with indefinite deferral of offshore compensation? It just seems to me, I do not know who is damaged, except perhaps U.S. taxpayers, because the more that is deferred—sure where the taxes are going to be when they are eventually paid out to the fund manager is an issue, but, on the other hand, all that is deferred and there is a build-up, and so on, and so forth, which is the whole thing. Tax delayed is a tax, in a certain sense, not paid.

So what I am trying to get at is, is there that difference in concept between deferred compensation for, say, an executive of a U.S. corporation on the one hand, where there is tension between the company and the executive, contrasted with foreign deferred compensation, where there really is no tension because the payor and the payee are pretty much the same entity?

Mr. SHAPIRO. There certainly is a difference in the structural arrangement between a manager and an offshore fund, because an offshore fund, you are right, does not give up a deduction because it is not looking for the deduction. So, yes, I would agree that there is a difference between a taxable corporation having a deferred arrangement with its employee and an offshore fund having a deferral with a manager.

I would say that in my experience, many years of working with fund managers, I do not know anyone who defers their fees indefinitely. I think that the general rule of thumb is somewhere up to 10 years, and very often it——

The CHAIRMAN. Well, most people do not live indefinitely, too.

Mr. SHAPIRO. Well, of course, when they die, the deferral is going to be paid out and there is going to be tax paid by their estate.

The CHAIRMAN. I guess one slight question here. A lot of people have very significant limits on their qualified deferred compensation, let us say, 401(k)s. I think a lot of people who have 401(k)s and limitations on their qualified deferred compensation wonder, why is there a limit on what I can defer, and a pretty severe limit, but no limit really on either general nonqualified deferred compensation, or even more in this case, with managers?

It is my understanding, too, and correct me if I am wrong, there are deferred limits for persons who work for nonprofits, like, say, a college or university, because again there is less tension there because you cannot take the deduction. A nonprofit cannot get a deduction from the payment, I do not think, to the employee. So I would just go back to the general sense of fairness in the minds, I think, of most Americans. Is it fair? Your response.

Mr. SHAPIRO. Of course, there is a difference between a deferred compensation arrangement either with a taxable corporation or an offshore fund, compared to tax qualified amounts that are basically protected from creditors and that sort of thing. So when a manager leaves funds offshore for some period of time, that becomes a liability which could, in extreme circumstances—and we have witnessed some extreme circumstances—actually be lost because it is a debt that could be not paid if the fund has significant losses.

So there is a difference between a tax qualified plan, a 401(k) plan, even an IRA, which is protected pretty much from creditors, and a non-qualified plan, either with a U.S. taxpaying corporation or an offshore fund.

The CHAIRMAN. I appreciate that. But my guess is, those who have non-qualified plans are able to take care of themselves pretty well by some other mechanism, some other way. I do not know.

Mr. SHAPIRO. Hopefully many of them do. Sure. They try to protect themselves by investing smartly and that sort of thing.

The CHAIRMAN. Sure.

I have to leave. I think Senator Grassley wants to return, and I think he will return shortly. So the committee will now recess until the call of the chair, which will be Senator Grassley, when he returns. I think, again, that will be in a very short period of time.

The committee is in recess.

[Whereupon, at 11:45 a.m., the hearing was recessed, reconvening at 11:54 a.m.]

Senator GRASSLEY. Thank you all for being patient. I was working on the SCHIP bill.

Senator Lott would like to have me ask this question before I ask six questions of my own, and then we will be done.

Mr. Berkley, what is your firm's effective tax rate? Would you care to speculate what the effective tax rate is for the property and casualty industry? The domestic property and casualty industry.

Mr. BERKLEY. Our effective tax rate is 35 percent. We are a full taxpayer, less our municipal bond income, which I cannot adjust for. I do not know exactly where that is, marginally. But we are a full taxpayer, other than credit we get from municipal bond holdings.

Senator GRASSLEY. All right.

Then can you give the effective tax rate, maybe an average, for the domestic P&C?

Mr. BERKLEY. I would assess that the domestic P&C industry is approximately the same thing currently, possibly a couple of points less. But it is a full taxpaying rate at the present time for almost all of the property and casualty industry, less the credit they receive from municipal bonds. And, in fact, the property and casualty industry is penalized because we do pay tax on part of our municipal bond income.

Senator GRASSLEY. All right.

Dr. Gravelle and Ms. Munson, the concern about rising tuition is something that is on the minds of students, parents, and even grandparents. And let me say, I think some of the ways that you have explained how high tuition has gone up ought to be out there in paid advertisements someplace. I was quite shocked when, in my own State of Iowa, Grinnell College recently announced a 12.6-percent increase. That would be $4,200. This is a time when Grinnell tuition and fees are at over $29,000, and at that rate are $10,000 higher than other private schools in Iowa, on average, and nearly $20,000 higher than our public schools.

As you alluded to in this testimony, Ms. Munson, this tuition increase comes from a college that has an endowment of $1.2 billion, as compared to the University of Iowa endowment of $295 million. I was particularly troubled that the justification given for this price increase was the need to bring the school's tuition "into line" with Grinnell's main competitors for students, Carleton College and Oberland College. This pricing decision seems to reflect more the thinking of a corporate CEO than the president of a charitable organization that benefits from tax-exempt status.

My question to you, or both of you, is, if we were to focus on these institutions with an endowment of over $500 million doing more and providing greater assistance to working families, would the impact be greater than what is experienced by just those attending these top colleges with big endowments? That is, will working families see the benefits of tuition costs being kept more in check because there is not a race to the top of colleges forever increasing tuition to bring themselves "into line" with other colleges?

Dr. GRAVELLE. Well, I guess as an economist I would say that you would expect the compression of tuition at the top would force the other schools to lower their tuition. In other words, there should be a cascading effect. Just as there is probably a pulling up effect from competing to raise tuition, there should probably be a cascading effect down. So you would expect tuition all along the line to begin to fall a little bit. That is what I would expect.

Senator GRASSLEY. Would that be the same for you, Ms. Munson?

Ms. MUNSON. Yes. Senator Grassley, I hope I did not misspeak. I believe Grinnell College's endowment is actually $1.5 billion.

Senator GRASSLEY. All right.

Ms. MUNSON. Yes. So they have a million in the bank for each undergraduate. And since they have no graduate students, obviously, that money should all be there for the purpose of serving undergraduate education. I believe they are spending just 2 percent of their endowment right now on financial aid, and, if they were spending 4 percent and dedicating that to financial aid, it would cover the cost of every single undergraduate, not just for tuition, but for room and board. It would be a totally free ride.

I am not an economist, so I do not have Dr. Gravelle's level of insight into cascading effects. It sounds like a logical idea. I do know that many schools imitate the actions of the schools with the largest endowments. For example, Yale has a rather well-known formula for calculating endowment payout over 3 years' time. Many, many schools use precisely the same formula.

I do believe that if Harvard and Yale, and the rest at the top, were to change their way of doing business, it would be widely imitated. It is also the case that more and more schools are in these upper ranks. I mentioned in my testimony about how the number of billion-plus has gone from 39 to 62 schools just in a few years. The number of schools in the $500-million-plus category of endowment has gone from 84 to 125 in the same period of time. So there are more and more schools in a position, perhaps, to eliminate, but certainly to substantially alleviate, the cost of attendance.

Senator GRASSLEY. To the two of you, I have heard that it is very difficult to get good information about individual college endowments, meaning, it is hard to figure out how big is the endowment, what is the payout, and what the endowment is spent on. Chairman Baucus and I have written to the IRS recently about making the Form 990 that charities must file with the IRS more transparent. We want to make certain that Form 990 is providing information that is very useful.

My first question is, how difficult is it to find out basic information on endowments, and what should be required on Form 990 and other information that colleges must report, or should report, for instance, to the Department of Education or to the college's own website?

The second question is, as you consider these issues of perhaps making changes to the rules regarding university endowments, what are the biggest challenges you see, for example, in defining what is an endowment or ensuring that the increased spending from an endowment brings real benefits to low- and middle-income working families?

Ms. MUNSON. Defining "endowment" precisely, Senator, is the key issue. It is the most difficult issue, and it is an issue that I raised with the IRS in my comments on the revisions to Form 990.

I have a copy of something called the John Harvard Letter here. It is kind of a bootleg copy of an annual bragging letter, I like to call these, that in this case the Harvard Management Company sends out to friends of the university. It illustrates this issue of how hard it is to define "endowment," in fact. Here they indicate that their endowment, the total investment return, by the way, in 2007, which has gone up so far 23 percent, they say that the endowment has gone up from $29.2 billion at the end of June of 2006 to $34.9 billion at the end of June of 2007.

Then, really in the same sentence, actually, they indicate that the total value of what they are calling the "general investment account," which they describe as including "the endowment and related accounts," grew from $33.7 billion to $41 billion. So what is the size of Harvard's endowment? It is what they are calling "endowment" and what I expect perhaps they might call "endowment" if the IRS asked them what their endowment was? Is it $35 billion as of June 2007 or is it $41 billion? That is a big difference, and that is a load of money, of course, in the first place.

Senator GRASSLEY. All right.

Dr. GRAVELLE. There is a lot of data that is not available unless you dig through financial statements, and even then there were cases where I could not find data on payout rates, on assets. On the return to assets, I was just lucky because somebody else did a study. There is no data that I can find, except one school, on the share of its offshore investments. It seems to me that is a very important question for this committee to know.

So I think that on the 990, it would be nice if the endowment could be separated and if these particular classes of investments that are of interest in public policy and the payout ratio, all that material, could be put either on the 990 or it could be required to be made available to the Department of Education. But I think there is something more than getting this data. It is also making it easily available. To gather data from the 990, you have to be a fairly accomplished researcher. You have to be able to extract this data, unless you just want to look at one university.

So if you want a picture of what is going on everywhere, I would say, decide what you really need to know and require the Education Department to post it on the Internet—every institution, the endowment, the return, the asset allocation, where they are putting their money. These are not private companies that will need to keep secrets. These are things that the public should know about in the interest of pursuing public policy.

So again, I looked on the 990 and I could not find the endowment for Harvard. I could find out how much Larry Summers was paid, but I could not find out how much the endowment was or how much they have offshore, or how much they had in different funds, or what the return was. So, I think those sorts of things I did in my study are important things to require schools to do, not to leave it to NACUBO (the National Association of College and University Business Officers). They will not give you individual institution information, and it is just as long as they have been in existence that we have any of this aggregated anywhere.

Senator GRASSLEY. Thank you.

Mr. Shapiro, currently a taxpayer employed by a tax-exempt organization is permitted to defer all, or a portion of, compensation. The tax laws applicable to this taxpayer currently provide that any deferred compensation will be taxable in the first year in which the compensation is no longer subject to a substantial risk of forfeiture. In this instance, the taxpayer may lose his or her right to compensation if, for example, the taxpayer leaves the organization before he or she is vested in the compensation. So would you answer these questions? I would like to ask them all at once. If it is too confusing, I will repeat them.

First, is it fair to characterize an offshore hedge fund as a tax-exempt entity because the foreign corporation generally does not pay any U.S. tax?

Two, in the context of offshore hedge funds, is it fair to say that compensation that is deferred by U.S. hedge fund managers is not subject to substantial risk of forfeiture? And also as part of that question, that is, is it fair to say the manager will get paid regardless of when or whether the manager ceases to provide services for the offshore hedge fund?

Then, lastly, should Congress tax compensation paid by an offshore hedge fund and deferred by a U.S. hedge fund manager like a taxpayer employed by a tax-exempt organization? That is, if compensation is not subject to a substantial risk of forfeiture, should the compensation be taxable immediately upon performance of services?

Mr. SHAPIRO. Well, fairness, I guess, is in the eyes of the beholder. I think that the rules that apply to employees of charitable organizations do not now apply to managers of offshore funds. Should they? I think that is the question that this committee is debating. But up until now, they have not been. The deferrals that are used by managers have business purposes, and I think they are particularly sanctioned by the current Internal Revenue Code.

As to whether those rules should be applied to an offshore entity, which is part of, I think, the question of, is an offshore fund the same as a tax-exempt organization? I think you could make that argument, in the sense that offshore funds generally, for lots of very good reasons that we all know and this Congress has approved, are not taxed on their capital gains income, not taxed on their interest income. They are taxed at 30 percent, generally, on dividend income.

The reason for the tax exemption, in the case of an offshore fund, is a policy reason, which is, we want those offshore funds to invest their money, just as foreign investors do, and the investors choose to invest through foreign corporations rather than individually. For a variety of reasons, we want them to invest. There is a whole policy of having them invest.

So they are tax-exempt in the sense that we have in the Internal Revenue Code a variety of rules that make those entities generally exempt from tax. Are they exactly the same as tax-exempt organizations in the United States? No. But there are similarities, I would agree with that.

The risk of forfeiture issue. I really do not have a definite answer as to how you want to deal with offshore fund deferrals. I think that offshore fund deferrals should be treated in a sort of even-handed way with any other deferred compensation packages that are developed by Congress, just as the recent section 409(a) rules clearly apply to hedge funds, apply to anybody who has deferred compensation.

Senator GRASSLEY. All right.

Mr. Berkley and Mr. Kramer, some view the reinsurance issue as a transfer pricing issue. That is, if the reinsurance premium is priced at arm's length, the U.S. tax system is collecting what it ought to collect with respect to the U.S. economic activity of these transactions. On the other hand, section 163(j) reflects the concern of tax policymakers, that, even if debt is priced at arm's length, the potential for stripping the U.S. tax base requires additional limitations on interest deductibility.

Two questions, and I will ask them both at the same time. Is this issue predominantly a transfer pricing issue? If so, are existing rules adequate to police potential abuse? Two, in what respects is this issue similar, or different from, the earnings stripping issue presented by related party debt?

Mr. KRAMER. Well, first, you do have, as we said, the excise tax as one issue. The second is that the business is transferred with substantial risk as opposed to what you would call earnings stripping, which is not analogous. Reinsurance is a high-risk transaction. The result is, there are periods when it goes exactly the opposite way, when the tax, as I said earlier in testimony, can be well over 100 percent because the excise tax exceeds the net loss, and the net loss is not tax offset in any way.

So I believe the current transactions are fair. I do not think the analogy is to earnings stripping. I do believe the reinsurance industry provides valuable capacity to the U.S. industry to write additional reinsurance or insurance.

Senator GRASSLEY. Mr. Berkley?

Mr. BERKLEY. Well, I think, first of all, one has to look at the fact that there is 2 to 3 times more reinsurance from affiliates to their parent or affiliate in Bermuda or foreign countries than arm's length transactions that happen with unaffiliated companies. That, in and of itself, tells you that something is happening.

Number two, I think it is very difficult to assess exactly whether the pricing is arm's length or not. We would assess that it is more favorable than not, but we think the 163(j) example of earnings stripping is appropriate, especially given the taxation method for insurance companies where the tax is based on the amount of business transferred, because the nature of property and casualty transaction taxation is that it is based on the discount of the amount of loss reserves moved offshore.

So when you move just a sheer larger amount of loss reserves than you would in an arm's length transaction, that, in and of itself, saves you tax and gives you an extended deferral. The longer the tail of the reserves or the longer you hold the reserves, the more valuable that deferral is. So, in commercial lines casualty business, it is an enormously valuable deferral, so we think 163(j), sir, would be, in fact, a very good example of what we are talking about. Transfer pricing. More effort by the Treasury and a little more strength could help on that, and that is an issue, but it is a smaller part of the issue.

Senator GRASSLEY. Mr. Kramer, according to the Dowling April 2007 report, the amount of U.S. premiums ceded to Bermuda affiliates varies from company to company. For example, in the previous year, 2006, 3 companies ceded more than 80 percent of their U.S. premiums to Bermuda, 6 companies ceded between 50 percent and 80 percent to Bermuda, 5 companies ceded less than 50 percent, and 1 company ceded zero percent.

Four questions. First, what explains this variation among Bermuda-based insurers? Two, what percentage of U.S. premiums does your company cede to Bermuda affiliates? Three, what factors affect the level of U.S. risk ceded to Bermuda affiliates? Fourth, how big of a factor is the ability to earn investment income tax free in Bermuda?

Mr. KRAMER. The first is that the wide variety of cessions indicates that there are other business reasons besides simply tax for ceding business between affiliates. It is more for the capital management and for risk distribution.

The second question.

Senator GRASSLEY. What percentage of U.S. premiums does your company cede?

Mr. KRAMER. My company does not.

Senator GRASSLEY. None? Zero?

Mr. KRAMER. At the moment, because we have an inactive company. Our Bermuda company is our only operating company.

Senator GRASSLEY. All right.

Then, three, what factors affect the level of U.S. risk ceded to Bermuda affiliates?

Mr. KRAMER. That, as I said, has to do with, first, I think, management of assets and capital. Also, there is a level of regulation. Remember that all these companies are State-regulated, so it is not simply taxed, or Federal, or transfer pricing, or excise, but it also happens to have State regulation involved in this as well.

These transactions simply cannot be done as alleged, as simply a paper transaction. These are substantial contracts between companies, and they need to be secured and they need to be able to pay, and the assets have to be available in the case claims are paid. So, there are several levels of regulation that look at this.

Senator GRASSLEY. And I suppose my last question you have already answered. You say there are many factors involved. Well, my question was, how big of a factor is the ability to earn investment income tax free in Bermuda?

Mr. KRAMER. Well, I think the ability to earn it, I think, is a factor. But the differential may not be as great as one may think because most of the business ceded to Bermuda, first, is short tail, that does not generate substantial investment income. Insurance companies only have two sources of income, premiums and investments. As Mr. Berkley points out, in the longer tail business, investment income is a more significant part of the total.

But again, if you take the differential between municipal bonds and the 1-percent excise tax on gross and realize that investment income is only probably 50 percent of income in a property and casualty company, then you are really dealing with a differential that is overcome by the excise tax, because the difference between municipal bonds which are tax-free at, let us say 4 percent, and in Treasury or other investments at 5 percent, the excise tax more than covers that twice over.

Senator GRASSLEY. Did you want to join in that, Mr. Shapiro? You looked like you were——

Mr. SHAPIRO. No.

Senator GRASSLEY. Mr. Kramer, again, I understand reinsurance relates primarily to risk taking. According to the Reinsurance Association of America, reinsurance with offshore affiliates is "undertaken to achieve corporate objectives that extend beyond risk sharing." What are those other objectives?

Mr. KRAMER. Well, I think it is capital management, among others. I am not sure of too many of the other issues. Certainly tax is an issue, there is no question about it. But it is just overblown when you look at the other factors that are involved, and it is offset, as I said, by both transfer pricing and excise tax.

Senator GRASSLEY. Mr. Berkley, in a follow-up to what Mr. Kramer says, you are unable to reinsure with offshore affiliates. What is your reaction to Mr. Kramer's comments, and how do you achieve those other corporate objectives, if at all?

Mr. BERKLEY. Well, we actually buy reinsurance, but we spend 6 percent of our premium to buy reinsurance to protect our company, as opposed to the 40, 50, 70, or 80 percent. If, in fact, we were to change from our commercial lines casualty focus to more of a property focus, that might go up, but it would still be—on average, our coalition spends 15 percent.

So I think that it is great to talk about risk transfer, but when you look at all the rest of the industry that does not have the affiliation offshore and you say they average 15 percent, it is fair to say there is something else going on.

In addition, I think, if you look at the history of the industry, in fact, it is not half of the profits that come from underwriting and half from investment income. The vast majority of the industry's profits over long-term history—not the past 5 years but over the long-term history—have come from investment income. The 1-percent premium tax is not based on the average portfolio of investable assets, it is based on the premiums that move offshore.

The invested assets that earn that higher return offshore accumulate over a period of time, so in fact there are many years of accumulated investable assets that build up over there. So I think, in fact, the tax issue is a much more significant factor in this picture.

Senator GRASSLEY. All right.

My last question is to Mr. Shapiro. What role do hedge funds play in the foreign reinsurance industry?

Mr. SHAPIRO. I am really not an expert on that, so I cannot give you any kind of definitive comment. I think some hedge funds participate to some extent in investment insurance policies or insurance premiums, but that is a new thing.

Senator GRASSLEY. If you do not have an overall view, do you know of any hedge funds that are deeply involved in reinsurance?

Mr. SHAPIRO. I do not know of any hedge funds that are really ostensibly involved in the reinsurance business. It is not a primary focus for hedge funds.

Senator GRASSLEY. But you at least know that there are hedge funds——

Mr. SHAPIRO. I know of one. I can think of one hedge fund that does participate with reinsurance companies in acquiring an aggregation of policies.

Senator GRASSLEY. All right.

Mr. SHAPIRO. But that is just one instance out of 8,000 or 9,000 hedge funds.

Senator GRASSLEY. All right.

For Chairman Baucus and the rest of the committee, and particularly for waiting for me to come back, I thank you very much for your cooperation and for your expert testimony.

[Whereupon, at 12:20 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Testimony of William R. Berkley

Chairman of the Board and CEO,
W. R. Berkley Corporation
Before the Senate Finance Committee
Washington, DC

September 26, 2007

Mr. Chairman, Ranking Member Grassley and members of the Committee, I am pleased to appear before you today to discuss a serious problem in our current tax system that provides a significant unfair competitive advantage to foreign property and casualty insurance groups based in no-tax or low-tax countries. Current law allows a U.S. member of a foreign–domiciled group to avoid paying U.S. tax on much of its domestic underwriting and investment income, merely by reinsuring its business with a related-party reinsurer domiciled in a country such as Bermuda or the Cayman Islands. By contrast, a U.S.-based insurance group must pay U.S. tax on all of its underwriting and investment income derived from writing similar domestic business.

This unfair tax advantage, which began to be exploited around 20 years ago, has already caused a significant migration of insurance capital abroad. If left unchecked, this could cause much more of the U.S. insurance capital base to migrate abroad and ultimately could threaten the future of our domestic insurance industry.

This is clearly one of the most important issues faced by my company since I founded it nearly 40 years ago. I am the Chairman and CEO of the W. R. Berkley Corporation, the Country's 9th largest commercial lines insurer with revenues over $5 billion. We operate in five major business segments: regional property casualty; specialty lines; reinsurance; alternative markets; and international. Our companies are located in 27 states and write business in all 50 states and the District of Columbia. We also conduct business in the U.K., South America and Asia.

However, today, I am testifying not only on behalf of my company, but also on behalf of a coalition of many of the other largest domestic commercial lines and financial guarantee insurers.

The other members of our coalition are:

AMBAC Financial Group, Inc.
American Financial Group, Inc.
Berkshire Hathaway Inc.
The Chubb Corporation
EMC Insurance Companies
The Hartford Financial Services Group, Inc.
Liberty Mutual
Markel Corporation
MBIA Insurance Corporation
Safeco Corporation
Scottsdale Insurance Company, a Nationwide subsidiary
The Travelers Companies, Inc.
Zenith Insurance Company

Collectively, we have over 150,000 employees, and approximately $1 trillion in assets with offices and employees located throughout the United States.

As competitors, we rarely agree on much. In this case, however, we are united in our belief that this tax inequity must be fixed and soon. Otherwise, the United States is at risk of losing much more of the capital base, and associated tax base, of one of its critical industries.

What is the unfair tax advantage and how does it work?

Current law allows foreign-domiciled insurers with U.S. affiliates to use related-party reinsurance transactions to strip their profits from both underwriting and investment activities out of the U.S. tax base (where the income was generated) to a more favorable tax jurisdiction. This transaction can be done instantly and generally requires only a book-keeping entry.[1] By contrast, U.S.-based insurers must pay current

[1] In such cases, the foreign-domiciled insurance group pays only a one-percent excise tax on the reinsurance premiums paid from the U.S. member to its offshore affiliate. Once those resources are located in the low-tax or no-tax country, any income earned is taxed only at the local rate. In the case of Bermuda, there is no corporate income tax on that income.

U.S. tax on all of their income from these policies. Thus, even though the U.S. income-generating activities are the same, these foreign-domiciled insurers can avoid tax on much if not all of their underwriting and investment income and generate significantly greater after-tax returns than comparable U.S. competitors.

This is an enormous competitive advantage and is particularly advantageous for commercial lines and financial guarantee insurers where loss reserves are held for an extended period of time and generate substantial investment income. Thus, for these "long-tail" lines of business, avoiding U.S. tax on investment income gives foreign-domiciled groups an even greater competitive advantage over their U.S. counterparts.

All of this provides an incentive to locate capital in low-tax or no-tax jurisdictions in order to take advantage of the benefit afforded foreign-domiciled insurance groups. As the premium ceded outside the U.S. increases, the foreign-domiciled insurers will continue to use their tax advantage to gain a greater share of the U.S. insurance market.

Both the Bush Administration and this Committee have previously expressed concern over this inequitable tax advantage and the need for a fix. In written testimony before the Congress in 2003, then Treasury Assistant Secretary Pam Olson stated:

> The Treasury Department is concerned about the use of related party reinsurance to avoid U.S. tax on U.S. source income. In particular, the use of related party insurance may permit the shifting of income from U.S. members of a corporate group to a foreign affiliate. Existing mechanisms for dealing with insurance transactions are not sufficient to address this situation.

In adopting a provision to clarify the transfer pricing rules in section 845 in 2004, the Finance Committee tried to fix the problem and stated "The Committee is concerned that foreign related party reinsurance arrangements may be a technique for eroding the U.S. tax base."

Unfortunately, the adjustment to the transfer pricing rules adopted in 2004 failed to stem the tide (as evidenced by Appendix 1), since at bottom, the core problem is not effectively addressed by transfer pricing rules. As the Joint Committee pamphlet for this hearing acknowledges, it is difficult for the IRS to use transfer pricing rules to police such transactions, because such rules -- as the name suggests -- are limited to arm's length pricing. In this case, the unfair tax advantage causes foreign-controlled insurers to cede more business to foreign affiliates than they would ever cede to an unrelated party. Moreover, because of the numerous variations in the terms and conditions of reinsurance contracts and because the true costs of insurance products are not known until long after prices are established, determining a true arm's length price in this context is exceptionally difficult. Finally, the mere ceding of reserves offshore, even without a shift in underwriting profits, dramatically lowers tax payments because of the requirement in the U.S. to discount loss reserves.

If the transfer pricing rules worked, we would expect that the bulk of the profits would remain in the U.S. and the competitive tax advantage would disappear. However, most Bermuda insurers have exceptionally low effective tax rates, including those groups writing insurance business through U.S. subsidiaries. This demonstrates their success in transferring the bulk of their underwriting and investment income offshore to avoid tax under existing mechanisms. Thus, we do not believe that the provisions of section 845 will effectively prevent or alter the many related party reinsurance transactions that take place under current law.

When Congress became aware of a similar problem with respect to debt, it addressed the problem by curtailing the amount of tax-favored borrowing by U.S. firms from related foreign parties. Congress did not address the problem through the transfer pricing rules, because it recognized that those rules were not capable of dealing with the problem.

Why must we act now?

The migration of capital, which began in the mid-1980s, has continued in earnest. Over the last decade, the U.S. insurance industry has been shifting offshore at an accelerating pace.

Previously, a number of U.S. property and casualty insurance and reinsurance holding companies chose to expatriate to low-tax or no-tax countries with a principal purpose to avoid U.S. taxes. Among the most notable, White Mountains Insurance Group, Everest Re Group, Arch U.S., and PXRe Group LTD all inverted into Bermuda-based parent corporations. More recently, as described more fully below, Argonaut engaged in a partial inversion into Bermuda, avoiding treatment as a domestic corporation under section 7874.

As Appendix 2 shows, companies in Bermuda have been actively acquiring U.S. insurance companies and lines of business. For example, upon completion of their inversions to Bermuda, several of the previously U.S.-based multinationals have aggressively acquired other U.S. insurers and assets to further avail themselves of this unfair tax advantage. These acquisitions of U.S. insurers and reinsurers include ACE's acquisition of CIGNA's former INA companies and XL's acquisition of NAC Re.

The tax advantage also provides an incentive for the formation of new companies in no-tax and low-tax jurisdictions. Once formed, these new companies seek to acquire U.S. companies or lines of business in order to benefit from the tax advantage.

The following are just a sample of the transactions where tax benefits were a principal reason for the transaction:

- **Inversion of Arch U.S.** On November 8, 2000, Arch U.S. inverted, becoming a wholly-owned subsidiary of Arch Capital Group Ltd. (ACGL), a Bermuda holding company. The shareholders of Arch U.S. became the shareholders of ACGL. Subsequently, Arch Insurance Company (AIC), a U.S. subsidiary of ACGL, entered into a quota share reinsurance agreement with its Bermuda-based affiliate, Arch Reinsurance Ltd, whereby AIC generally cedes 80% of its net retained liability to Arch in Bermuda. ACGL has had several substantial equity infusions of capital since its inversion.

- **Inversion of United National.** United America Indemnity, Ltd. was established as a Cayman Islands holding company on

August 26, 2004 to acquire the United National Group's U.S. insurance operations. Subsequently, the Company added the Penn-America Group, Inc. segment to its U.S. operations. United America also includes a non-U.S. operation: Wind River Reinsurance Company, Ltd. in Bermuda, which provides reinsurance to the U.S. operations. United National Insurance Company cedes 60% of its business to Wind River, while Penn-America Insurance Company cedes 30% of its business to Wind River.

- **Partial Inversion of Argonaut**. On May 14, 2007, Argonaut Group, Inc., a San Antonio, Texas specialty insurer merged into PXRE Group, Ltd., a Bermuda-based property reinsurer in a partial inversion transaction. The combined entity is doing business as Argo Group International Holdings Limited ("Argo Group"), a Bermuda holding company. Upon completion of the transaction, approximately 73% of Argo Group's outstanding common stock continued to be owned by Argonaut's shareholders. Management and the board are predominantly made up of the former members of management and the board of the U.S.-based Argonaut Group, Inc. While the business will continue generally to be U.S.-based, the transaction will allow the combined entity to shift much of the capital base and tax base offshore through related-party reinsurance to Peleus Re, a Bermuda-based reinsurance affiliate. While not specific, Argo Group has indicated that it will utilize internal reinsurance.

What are the consequences?

Such transactions have already resulted in billions of dollars of lost tax revenue to the federal government. At the end of 2006, over $70 billion of assets held offshore were owed by affiliated foreign reinsurers to related U.S. insurers as a result of affiliated reinsurance. In addition to the related underwriting income, these assets generate significant investment income outside of the purview of U.S. taxing authorities each year.

In addition, these transactions have caused significant migration of the U.S. capital base. For example, Bermuda companies and other offshore enterprises have received the vast majority of new capital raised by insurance companies in the past ten years.

Also, there has been significant growth in the amount of related party reinsurance written to foreign affiliates. In 2006, of the total $54.7 billion of U.S. premiums ceded to foreign insurance companies, $32.5 billion in premiums, or nearly 60 percent, was ceded to related foreign reinsurance companies. By contrast, in 1996, only $4.0 billion or 27.2 percent of the total $14.7 billion of premiums ceded to foreign reinsurers was ceded to related foreign companies. Thus, the amount of premium ceded to affiliated foreign reinsurers has increased at a 23.3 percent compound annual growth rate. If this growth rate continues, by 2012, premiums ceded to foreign affiliates will surpass $100 billion.

The data also demonstrates that the principal incentive for this increased related-party reinsurance activity has been the avoidance of U.S. income tax. As shown in Appendix 1, the bulk of this offshore activity is centered in low-tax or no-tax jurisdictions and such activity has increased more than eight-fold during the ten-year period from 1996 to 2006.[2]

Bermuda, which is a no-tax jurisdiction, accounts for over half of the total related party reinsurance of U.S.-based insurance in 2006. Since 1998, the number of major Bermuda-based reinsurance companies with U.S. affiliates has increased from three to over twenty. Related party reinsurance ceded to Bermuda companies by U.S. affiliates has increased ten-fold from $1.8 billion in 1996 to $18.5 billion in 2006.

This rapid growth in related party reinsurance means a concomitant loss of tax revenue in the United States. In addition to the negative impact on tax revenues, the movement of U.S.-based insurance capital offshore has other adverse consequences as well. For example, there will be significantly less demand for municipal securities, which are one of the industry's principal investments. In addition, as capital migrates offshore, ensuring that the insurance

[2] Two countries, Bermuda and the Cayman Islands, have no corporate tax while Ireland, with a 12.5 percent corporate tax rate, can be considered a low-tax jurisdiction. Switzerland generally has a higher statutory tax rate than Ireland; however, possible special relief may apply that could make the effective tax rate of a company located in Switzerland significantly lower than the statutory rate.

needs of the U.S. market are met may become more problematic in the long run.

What has changed?

Historically, offshore reinsurers served a narrow market in the United States, offering primarily catastrophe and high excess reinsurance protection. Today, however, offshore companies have expanded beyond these areas and into nearly all lines of the direct insurance business, including excess and surplus lines as well as standard market business. Much of this direct business is reinsured to offshore affiliates in low-tax or no-tax jurisdictions.

According to Dowling & Partners, "U.S. domiciled (re)insurers owned by Bermuda based holding companies wrote $30 BB+ of gross written premium in 2005 or more than 6% of U.S. commercial property/casualty premiums versus nothing a decade ago." Dowling then predicts, "ceding premium to offshore affiliates will continue to rise given recent/planned startups and the growing success of the Bermuda Class of 2001 (Arch & AXIS write nearly $3BB of primary insurance in U.S.). In addition, the recent Lloyd's expansion has a Bermuda Angle from a tax perspective."[3]

As Dowling & Partners notes in the same report, the reinsurance industry has already been lost to Bermuda as a result of the tax advantage, stating "there are no remaining independent publicly traded U.S. based reinsurers." We should not sit idly by and let the same migration occur with our primary domestic insurance industry.

What should be done?

To begin leveling the playing field and to preserve the U.S. capital and associated tax base, legislation needs to be enacted to prevent foreign-based insurers from stripping their income derived from U.S. business outside the U.S. taxing jurisdiction merely by reinsuring to a foreign affiliate. Only legislation can correct the unfair competitive advantage available to foreign-based groups.

[3] IBNR Weekly #46, Dowling and Partners (November 20, 2006)

Some essential points about eliminating the unfair competitive tax advantage:

- The fix should be limited only to affecting reinsurance ceded to foreign affiliates (i.e., from a U.S. member to a non-U.S. member of the same foreign group). Thus, offshore groups reinsuring risks for unaffiliated U.S. insurers should not be affected by the legislation.

- Fixing this problem should not adversely affect insurance capacity because any corrective legislation should be limited to related party reinsurance and not affect reinsurance transactions that spread risk among unrelated parties. The affected related party reinsurance transactions add no additional capacity to the market, but rather require a mere bookkeeping entry to move premium from the U.S. company's pocket to the foreign parent's pocket of the same corporate family.

- The fix will not adversely impact the creation of meaningful jobs where underwriting and sales are actual components of writing the reinsurance abroad. Because the tax-driven transactions generally require only a book-keeping entry and merely shift revenue from one pocket to another, they require little in the way of additional facilities or personnel in the low-tax or no-tax jurisdiction.

- Fixing the unfair tax advantage is not protectionist, as our competitors have argued in the past, because it does not favor domestic companies over foreign competitors. The fix merely would level the playing field by similarly taxing U.S. insurers and their foreign-based competitors in writing U.S. business. We do not believe we should receive special treatment in accessing foreign markets relative to our foreign competitors, nor should our foreign-based competitors be advantaged in the U.S. market relative to us under the tax code.

In closing, I believe that legislation addressing this problem is critical to the continued existence of a robust domestic insurance industry. I want to thank Chairman Baucus, Senator Grassley and the other Members of the Committee for inviting me to express my views regarding this important and complex issue. I would welcome the opportunity to answer any questions that you may have.

Appendix 1 – Related-Party Reinsurance Ceded Activity
Top Jurisdictions
Reported from 1996 to 2006
Source: Reinsurance Association of America
(In Millions of Dollars)

Country	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Bermuda	1,783	1,799	3,704	5,192	6,225	8,829	8,825	14,199	17,031	18,590	18,474
Switzerland	660	609	728	466	670	3,173	6,168	7,480	7,795	7,664	7,991
Germany	264	326	355	421	484	799	6,253	4,269	3,294	9,401	2,005
Barbados	230	317	258	229	219	382	841	1,064	925	917	965
Sweden							38	37	38	90	518
Ireland			86	-111	25	218	273	203	177	165	451
Cayman Islands	73	256	583	951	884	998	1,072	894	629	646	435
United Kingdom	292	326	336	381	417	428	489	1,470	300	252	346
France	103	101	92	115	216	590	422	403	198	293	338
British Virgin Islands							28	38	49	72	327
Other	596	481	299	1,205	579	442	485	606	704	726	620
Total	4,001	4,215	6,441	8,849	9,719	15,859	24,894	30,663	31,140	38,816	32,470

- Includes two significant one-time affiliated loss portfolio transactions.

Appendix 2 – Selected Transactions

Group	Quota Share Details	Initial U.S. Acquisition or Entry into U.S.
White Mountains Insurance Group Ltd.	No business Quota Shared from One Beacon to Bermuda.	*Redomesticates in Bermuda*, October 1999
Everest Re Group Ltd.	35% of Everest Reins Co's casualty business & 20% of property ceded to Bermuda. Everest Reins. Co assumes 85% of net business from Everest National, Everest Indemnity and Everest Security.	*Redomesticates in Bermuda in* 2000
Arch Capital Group Ltd.	90% of net U.S. business ex. alternative market profit center and lenders product.	Capital infusion (October 2001); Arch Re Bermuda (formed May 2001
Endurance Specialty Holdings Ltd.	Endurance Re Corp of America (NY) cedes 50% to Bermuda Traders & Pacific (DE) cedes approx. 60% to outside reinsurers and 90% of remaining to Bermuda.	Endurance Re of America formed 2002
Platinum Underwriters Holdings Ltd.	75% of Platinum U.S. business ceded to Bermuda.	Redomesticated in Bermuda, 2002 IPO.
United American Indemnity, Ltd.	60% of United National Ins Co business; 30% of Penn-America Ins Cos business ceded to Bermuda	Formed United National Bermuda 2003
RenaissanceRe Holdings Ltd.	Glenco (Bermuda) provides 50% QS to Stonington (TX), which reinsures 80% of Lantana, Newstead and Inverness and 100% of Stonington Lloyds	DeSoto Companies formed in 1997; Acquired Nobel 1998
Allied World Assurance Company Holdings Ltd.	Cedes 85% of ultimate net liability to AWAC Bermuda.	Formed November 2001; Formerly AIG subsidiary
PXRE Group Ltd.		*Redomesticates in Bermuda*, October 1999
Lloyd's Syndicates	Various	*Redomesticates in 2007* Amlin, Hiscox, Omega Specialty, Kiln, Advent
ACE Ltd.		Westchester (acquired 1998); CIGNA P&C (1999)
XL Capital Ltd.	XL Re America cedes 75% of pooled business to XL Re Ltd (Bermuda) after placement of specific reinsurance	Folksamerica General (acquired 1998); NAC Re/Intercargo (1999)
PartnerRe Ltd.	Partner Reins Co of U.S. cedes 25% of all lines to Bermuda	Safr Re (acquired 1997); Winterthur Re (1999)
Axis Capital Holdings Ltd.	Axis Specialty cedes 50% of all U.S. business to Bermuda.	Royal & Sun Personal (acquired 2002); CT Specialty (2002)
Alea Group Holdings Ltd.	N/A – runoff	Acquired Seven Hills Insurance Company (2001)
Quanta Capital Holdings Ltd.	N/A – runoff	Chubb Financial Solutions (acquired 2003); NFU (2003)
Aspen Insurance Holdings Ltd.	50% of net U S. casualty business ceded to Bermuda. No QS on property.	Dakota Specialty (acquired 2003)
Max Capital Group Ltd.	Started writing E&S in first half 2007.	Formed in Bermuda in 2000; Acquires U.S. Based excess and surplus lines company, renamed Max Specialty Insurance Company (April, 2007)
Argonaut Group, Inc. and PXRE Group Ltd.	New- no information available.	Signed a definitive merger agreement; combined entity will do business as Argo Group International Holdings Limited; (March 2007)
James River Group	New – no information available.	D. E. Shaw reached an agreement to acquire James River Group, Inc. through a Bermuda holding company in 2007. D.E. Shaw will create and capitalize a new Bermuda reinsurer after the close.
Tower Group Inc./ CastlePoint Holdings	Tower cedes 30% of brokerage business and traditional program business to CastlePoint Re.	Castle Point formed in Bermuda in 2006 by management and shareholders of Tower Group
Ironshore Inc.	Writes E&S business direct in U.S.	Ironshore Ltd formed in Bermuda and approved for surplus lines in certain states in 2007.
AmTrust Financial Services, Inc. / Maiden Holdings Ltd.	40% QS of AmTrust Group business to Maiden	Principal shareholders of AmTrust form Maiden Holdings and Maiden Insurance Company Ltd. 2007
Montpelier Re	New- no information available.	Received Coverholder approval from Lloyds for U.S. MGU to write property brokerage facultative business in the U.S.. Purchased surplus lines shell company from GAINSCO in August 2007 and will write primarily excess and surplus lines insurance in the U.S.
Ariel Holdings Ltd.	New- no information available.	On September 20, 2007 Ariel Holdings announced its intention to acquire Valient Ins. Co., a licensed admitted carrier in 47 states. Will serve as the operating platform for a new specialty P&C initiative.

Source: Dowling & Partners, IBNR Weekly #46, Vol. XIII November 20, 2006; Dowling & Partners, IBNR Weekly #15, Vol. XIV April 13, 2007; company press releases.

Questions for the Record
Offshore Tax Issues
September 26, 2007
Questions for Mr. Berkley

Chairman Baucus

1. The Treasury Department and Congress have identified the ability of foreign-based insurers to avoid taxes when reinsuring with a U.S. affiliate as a problem that needs to be corrected. As a result, in 2004, Congress included a provision in the JOBS Act to address it by treating this as a transfer-pricing problem. Did this work? How do you reach your conclusion?

Response: While Congress properly recognized the competitive problem caused by offshore related party reinsurance, the modifications to the transfer pricing rules in the JOBS Act did not sufficiently address the problem because the core problem is not effectively addressed by transfer pricing rules. As evidenced by Appendix 2 in my testimony, the amount of offshore related-party reinsurance continues to grow significantly, apparently unfettered by the change. Since my testimony, there have been several significant acquisitions of U.S. lines of business by foreign-based groups.

As the Joint Tax Committee acknowledged in its pamphlet for this hearing, it is difficult for the IRS to use transfer pricing rules to police such transactions, because such rules -- as the name suggests -- are limited to arm's length pricing. In this case, the unfair tax advantage causes foreign-controlled insurers to cede more business to foreign affiliates than they would ever cede to an unrelated party. Moreover, because of the numerous variations in the terms and conditions of reinsurance contracts and because the true costs of insurance products are not known until long after prices are established, determining a true arm's length price in this context is exceptionally difficult. But fair pricing is only part of the issue. Most people think that taxes for insurers are based on underwriting income, yet they are primarily derived from investment income on reserves, particularly for long-tailed lines of business. These variations could affect when the losses are paid, thereby changing the investment income. Even if a reinsurance transaction with an affiliate is fairly priced, it does not consider the payment pattern and investment return on loss reserves. Finally, the mere ceding of reserves offshore, even without a shift in underwriting profits, dramatically lowers tax payments. The 1986 Tax Reform Act established the requirement in the U.S. to discount loss reserves thereby accelerating the payment of taxes. When reserves are ceded offshore, the discount is not required. This disparity is not considered in the transfer pricing rules.

It is evident that the adjustment to the transfer pricing rules adopted in 2004 has failed to stem the tide of offshore companies (including many newly-established ones) acquiring U.S. subsidiaries and then having them reinsure the bulk of their business to offshore affiliates. If the transfer pricing rules worked, we would have expected that the bulk of the profits would have remained in the U.S. and the competitive tax advantage would have disappeared. However, most Bermuda insurance groups writing insurance business through U.S. subsidiaries have exceptionally low effective tax rates. This demonstrates their success in transferring the bulk of their underwriting and investment income offshore to avoid tax under existing mechanisms. Thus, we do not believe that the modifications to section 845 have effectively prevented the stripping of income overseas through the many related party reinsurance transactions that take place under current law.

When Congress became aware of a similar problem with respect to debt, it addressed the problem by curtailing the amount of tax-favored borrowing by U.S. firms from related foreign parties. As the Joint Tax Committee states in its hearing pamphlet, "a set of definitive rules similar to the earnings stripping rules would probably have a more systematic effect on taxpayers than relying on transfer pricing principles."

Senator Grassley

1. At the hearing, you said that related party reinsurance is merely a bookkeeping entry. Please elaborate on what you mean by that. Are you suggesting that related party reinsurance lacks economic substance?

Response: The statement that related party reinsurance is merely a bookkeeping entry referred to the fact that, in most cases, the business is produced, underwritten and serviced here in the United States, but through a reinsurance transaction with an offshore affiliate, the profits are stripped overseas outside of the purview of U.S. taxing authorities. The primary insurance transaction requires a lot of people and work, whereas the reinsurance transaction between affiliated parties requires only a few people to accept the terms and reflect it on the books. With a common parent and shared interests, there is little if any need to review the work of the underlying primary underwriters. Since they are relying on the work of the underlying primary underwriters, the business moves with no consequential work involved.

Similarly, companies can move their loss reserves to an offshore affiliate by entering into a contract like a Loss Portfolio Transfer, such as a large Bermuda-based company did in the first quarter of 2007, when the members of its U.S pool ceded $1 billion of reserves via a loss portfolio transfer to its Bermuda affiliate. The U.S. pool companies recorded a like amount of ceded premiums and losses on their income statement. Through this bookkeeping entry, the reduction in reserves resulted in a tax deduction to the extent of the reserve discount. Additionally, investment income on $1 billion of assets associated with the reserves transferred to Bermuda under the LPT would have otherwise continued to generate taxable investment income in the U.S.

Rupp's Insurance & Risk Management Glossary (© 2002, NILS Publishing) defines a loss portfolio transfer as "the transfer of incurred losses to a third party. The assuming party hopes to profit by investing the sale price it has received over the length of time it requires to settle the claims it has assumed. Such transfers are undertaken by insurers or self-insureds in order to gain tax advantages, to clean up a financial statement, or to exit from a line or class of insurance." This demonstrates how commonplace it is for companies to use such bookkeeping transactions to gain tax advantages.

2. Some view the affiliated offshore reinsurance issue as a transfer pricing issue, while others draw an analogy to "earnings stripping" through the use of related party debt. I understand your view to be that it is an earnings stripping. Please explain in more detail (i) why you think this is not a transfer pricing issue, (ii) why current law transfer pricing rules, and enforcement of those rules, are not sufficient to police related party reinsurance transactions, and (iii) how the tax issues associated with related party reinsurance are similar to, or different from, the tax issues associated with related party debt.

Response: (i) The overall problem is not a transfer pricing issue per se. The amount of U.S.-written business being ceded by U.S. members of foreign-based groups to such related offshore parties is significantly greater than would ever be ceded to an unrelated party. The cession of larger amounts than is normal is not policed by transfer pricing restrictions and also makes it virtually impossible to find meaningful comparables. Moreover, use of related party reinsurance allows foreign-based groups to avoid significant elements of our tax system, providing them a significant competitive tax advantage over domestic insurers. For example, by allowing them to shift their reserves on domestically-written business overseas, the use of related-party reinsurance allows foreign-based groups to avoid U.S. tax on the bulk of their investment income. It also allows them to avoid U.S. rules requiring discounting of loss reserves, which accelerate the payment of taxes by domestic groups. Thus, it is not just a transfer pricing issue. It is, in part, a volume issue as the more business that is moved offshore, the more a foreign-based group can avoid these features of our tax system.

(ii) For several reasons, we agree with the Joint Tax Committee that it is difficult for the IRS to use transfer pricing rules to police related party reinsurance transactions. First, as described above, the fact that foreign-controlled U.S. insurers cede more business to foreign affiliates, by itself, provides competitive tax advantages that cannot be meaningfully addressed under transfer pricing rules. Moreover, it is extremely difficult to measure arm's length compensation for risk transfer in this business. Reinsurance profitability is determined by the timing of claim payments and the investment income earned until such payments are made, not by the theoretical incurred losses. Assessing risk transfer in the insurance business requires not just the knowledge of expected loss ratio, etc., but also knowledge of payment patterns which can be changed by the words in the reinsurance contract. Because of the numerous variations in the terms and conditions of reinsurance contracts and because the true costs of insurance products are not known until long after prices are established, determining a true arm's length price in this context becomes exceptionally difficult.

(iii) The tax issues associated with related party reinsurance and related party debt are very similar. They both involve a systematic reduction of the U.S. tax base by stripping income out of the U.S. through payments to overseas affiliates. With respect to debt, Congress addressed the problem by disallowing deductions for "excessive" interest payments by U.S. firms to related foreign parties. In making this change, Congress stated, "To allow an unlimited deduction for such interest permits significant erosion of the tax base... [T]his ability to avoid tax tends to give an unfair advantage to businesses owned by foreign and other tax-exempt persons, as compared with business operations owned by taxable U.S. persons." Similar issues pertain to the use of related party reinsurance in that the transaction is utilized to create a tax deduction in the US that shifts income outside of the purview of U.S. taxing authorities. Thus, we believe that an anti-stripping provision similar to that applied to related party debt (i.e., disallowing an immediate deduction for excessive related-party reinsurance) would be the best approach for addressing the problems that concern us. We agree with the Joint Tax Committee that this approach would "probably have a more systematic effect on taxpayers than relying on transfer pricing principles."

3. According to the Reinsurance Association of America, reinsurance with offshore affiliates is "undertaken to achieve corporate objectives that extend beyond risk sharing." At the hearing, Mr. Kramer acknowledged that tax was a factor, but said the key objective is capital management. How do the members of your coalition achieve efficient capital management?

Response: Members of the Coalition most often utilize pooling arrangements to achieve efficient capital management among their various operating subsidiaries, which results in a sharing of risk over a combined capital base that resides in the U.S. If on a combined basis the groups do not have enough capital to bear the risk assumed in their business, they typically achieve the desired balance by purchasing excess of loss reinsurance from third party reinsurers. Foreign–domiciled groups may also use inter-company transactions to efficiently manage their capital. Because of the nature of taxes on insurance, many foreign-domiciled groups frequently elect to use pro-rata reinsurance that requires large amounts of money to be transferred outside of the purview of U.S. taxing authorities. If they were just interested in balancing their risk, they would be more likely to use excess of loss reinsurance. The Coalition members are not attempting to prevent foreign-based groups from achieving this efficient capital management objective. The members do, however, believe that foreign-based groups should not gain an unfair tax advantage for doing so. U.S. based groups continue to pay taxes on the pooled business because it remains within the purview of U.S. taxing authorities. In contrast, foreign-domiciled groups have an incentive to utilize affiliated reinsurance so they can transfer their investable assets offshore where the investment income can be earned outside of the purview of U.S. taxing authorities.

4. Your coalition contends that current tax treatment of related party reinsurance for foreign-based insurers and reinsurers gives them a competitive advantage over domestic-based P&C companies. Please describe, in detail, the nature of the competitive advantage. Does the advantage manifest itself through lower pricing for consumers or increased capacity? What would happen in the domestic P&C market if taxes were raised in the manner you suggest?

Response: The current tax treatment of related party reinsurance for foreign-based insurers and reinsurers gives them a competitive advantage over domestic-based P&C companies as it results in higher returns on equity (ROE) for foreign-based groups. This results because the use of related-party reinsurance allows them to strip income overseas to a low-tax or no-tax jurisdiction and avoid federal income taxes on a substantial amount of the income derived from a domestically-written policy. In contrast, a U.S.-controlled insurance group must pay current U.S. tax on all profits (including any investment income) derived from such policies. Thus, due to their lower tax burden, such foreign-based groups are able to offer their investors a significantly higher after-tax ROE than domestic groups from writing insurance policies covering U.S. risks. Ultimately, this makes the foreign-based groups more attractive to investors, providing a competitive advantage in raising new capital.

The proposed legislation should not adversely affect insurance capacity, because it is limited in scope to reinsurance between related parties and thus would not apply to real reinsurance transactions that spread risks among unrelated parties. The affected related party reinsurance transactions add no additional capacity to the market, but rather require a mere bookkeeping entry to move premium from the U.S. company's pocket to the foreign parent's pocket of the same corporate family. In fact, we believe the proposal will help to sustain a healthy domestic insurance market and preserve the real reinsurance market that truly spreads insurance risk among unrelated companies.

Historically, this advantage has not resulted in lower prices to consumers. For example, there was a dramatic hardening of pricing in the U.S. property and casualty insurance market in the years following 9-11 in 2001 and following the hurricanes in 2005 – both times when significant additional capital was being raised in the U.S for foreign-domiciled companies to write U.S. business. Had the tax advantage not existed, domestic companies still would have raised the increased capacity because of the higher expected returns. Instead, the capital flowed offshore to garner even higher prospective returns as a result of the tax advantage. Recently, pricing has softened in the market, and the head of the Association of Bermuda Insurers and Reinsurers was quoted in an article in <u>National Underwriters</u> last month saying that the profits Bermuda companies are making "is going back to shareholders. It's not contributing to the downward spiral [in commercial insurance pricing]." In other words, pricing in the U.S. property and casualty insurance market – whether in a soft market or a hard market -- has not been impacted by the tax advantage or <u>where</u> the capital is raised.

Moreover, regardless of how the tax benefit is used, it arises from an unfair competitive tax advantage for foreign-based companies at the expense of their U.S. competitors and other U.S. taxpayers. The U.S. tax system should not favor foreign-based insurers over U.S. companies in writing insurance covering U.S. risks.

5. Bermuda insurers and reinsurers have been a major player in the domestic P&C market since at least the early 1990's (after Hurricane Andrew). Have these companies taken market share away from domestic companies or other foreign companies, or have they filled an otherwise unfilled demand for insurance or reinsurance?

Response: Offshore companies have expanded into nearly all lines of direct insurance, including excess and surplus lines as well as standard market business such as workers' compensation. Much of this direct business is reinsured to offshore affiliates in low or no tax jurisdictions. In 2006, the amount of premiums reinsured to foreign affiliates was $32.5 billion, including $18.5 billion to companies located in Bermuda. This compares to a total of $4 billion of premium ceded to foreign affiliates in 1996. As a result underwriting profits are moved out of the purview of U.S. taxing authorities. In addition, by moving the assets supporting the reserves offshore, investment income is no longer taxed in the U.S.

Companies owned by foreign parents have taken market share away from U.S. domiciled groups over the past ten years. They have not met an unfulfilled demand, as the industry has more than sufficient capacity and the capital raised in the wake of 9-11 and the 2005 hurricanes would have flowed to domestic companies had the tax advantage not existed because of the higher expected returns. Since 1997, the market share of direct premiums written by groups domiciled outside of the U.S. has risen from 5.1% to 10.9% representing over $54 billion in direct premiums written in 2006. The bulk of the increase in this market share of non-U.S domiciled groups has occurred in Bermuda, where the market share of insurers and reinsurers has risen from 0.1% to 4%, Remarkably, the percentage of premiums ceded to affiliates represented by foreign-domiciled groups has risen from 13% to 67% over the same period.

6. Please provide me with your coalition's reaction to the letters written by the Risk and Insurance Management Society to Chairman Baucus and by the Florida Consumer Action Network to Senator Bill Nelson.

Response: The letter written by the Risk and Insurance Management Society to Chairman Baucus dated August 6, 2007 focused on the importance of reinsurance as a resource to control and finance risk and the necessity of a competitive and innovative global insurance and reinsurance marketplace. It urged Chairman Baucus to oppose legislation that would encumber free market movement and the transfer of risk that is so vital to a sound global insurance and reinsurance community. The Coalition agrees with these important concepts. However, the current law tax advantage for foreign-based groups over domestic-owned groups actually stifles fair competition and encumbers the free market environment and the transfer of risk. The Coalition is not seeking preferential treatment that would disadvantage foreign-based groups. The Coalition For A Domestic Insurance Industry is seeking legislation that would merely begin to create a level competitive playing field. There is no reason the U.S. tax system should favor foreign-based insurers over U.S. companies in writing insurance covering U.S. risks.

Further, the letter submitted to Senator Bill Nelson by the Florida Consumer Action Network on July 6, 2007 expresses concern over any government policy that would discourage reinsurance companies from assuming hurricane risk and end up costing consumers in the form of higher insurance costs to Floridians. It also characterizes the goals of the Coalition as protectionist. As we responded in question 4, the proposal would not impact capacity or pricing for consumers. In actuality, in the current environment, reinsurers are diverting capital away from reinsurance to primary business. If they are no longer able to take advantage of the tax benefit, they may change their behavior and put their capital back to work writing reinsurance. The legislation being sought is not meant to affect foreign reinsurers providing third party reinsurance to unaffiliated U.S. insurers. Consequently, it would not affect the market for catastrophe coverage that protects Americans from natural disasters.

Fixing the unfair tax advantage is not protectionist because it does not favor domestic companies over foreign competitors. The fix merely would level the playing field by similarly taxing U.S.-owned insurers and their foreign-based competitors in writing U.S. business. We do not believe we should receive special treatment in accessing foreign markets relative to our foreign competitors, nor should our foreign-based competitors be advantaged in the U.S. market relative to us under the tax code.

In the long run, a problem could arise in times of crises when no domestically-owned companies remain and the insurance industry is no longer a part of U.S. society.

Questions from Senator Lott

1. In your testimony, you point to the competitive disadvantage that U.S.-based insurers face due to the ability of foreign domiciled insurers with U.S. affiliates to effectively strip their profits from underwriting and investment activities out of the US tax base to a more favorable jurisdiction like Bermuda, by simply using related party reinsurance. I recognize that we are here today to simply determine if such a competitive disadvantage really does exist, but assuming that it does, what do you propose as a solution?

Response: It is unfair that our tax code gives foreign insurance companies a competitive advantage over U.S. companies on writing insurance in this country.

Allowing the loophole to continue subsidizes offshore business at the expense of all American taxpayers.

This problem can be solved only through legislation. Congress can and should pass legislation this year to eliminate this loophole and ensure that foreign-based insurance groups pay U.S. income tax on their U.S.-based income. Our proposed solution is similar to the earnings stripping rules applicable to related party debt. It would simply defer the deduction for certain reinsurance premiums paid by a U.S. property and casualty insurance company to a foreign affiliate. Subsequently, when losses are paid under the reinsurance arrangement, the U.S. company would be entitled to a deduction equal to the amount of such loss recoveries. By deferring the deduction for related-party reinsurance, this proposal effectively subjects a foreign-based group to tax on the investment income earned on its reserves attributable to domestic business, helping to level the playing field for domestic insurers.

Action is needed now before more companies relocate abroad or are purchased by overseas companies, and more tax revenues are lost.

2. I know that Congress attempted to address this competitive disadvantage issue in the 2004 Jobs bill via transfer pricing rules. Do you think that was an adequate response, or should Congress look at other proposals to close this loophole. What other solutions would you recommend to this Committee?

Response: The JOBS Act did not sufficiently address the problem created by the ability of foreign-based insurance groups to avoid taxes through the use of related-party reinsurance because the transfer pricing rules do not effectively address the core problem. As evidenced by Appendix 2 in my testimony, the amount of offshore related-party reinsurance continues to grow significantly, apparently unfettered by the change. Since my testimony, there have been several significant acquisitions of U.S. lines of business by foreign-based groups.

As the Joint Tax Committee acknowledged in its pamphlet for this hearing, it is difficult for the IRS to use transfer pricing rules to police such transactions, because such rules -- as the name suggests -- are limited to arm's length pricing. In this case, the unfair tax advantage causes foreign-controlled insurers to cede more business to foreign affiliates than they would ever cede to an unrelated party. Moreover, because of the numerous variations in the terms and conditions of reinsurance contracts and because the true costs of insurance products are not known until long after prices are established, determining a true arm's length price in this context is exceptionally difficult. But fair pricing is only part of the issue. Most people think that taxes for insurers are based on underwriting income, yet they are primarily derived from investment income on reserves, particularly for long-tailed lines of business. These variations could affect when the losses are paid, thereby changing the investment income. Even if a reinsurance transaction with an affiliate is fairly priced, it does not consider the payment pattern and investment return on loss reserves. Finally, the mere ceding of reserves offshore, even without a shift in underwriting profits, dramatically lowers tax payments. The 1986 Tax Reform Act established the requirement in the U.S. to discount loss reserves thereby accelerating the payment of taxes. When reserves are ceded offshore, the discount is not required. This disparity is not considered in the transfer pricing rules.

It is evident that the adjustment to the transfer pricing rules adopted in 2004 has failed to stem the tide of offshore companies (including many newly-established ones) acquiring U.S. subsidiaries and then having them reinsure the bulk of their business to offshore affiliates. If the transfer pricing rules worked, we would have expected that the bulk of the profits would have remained in the U.S. and the competitive tax advantage would have disappeared. However, most Bermuda insurance groups writing insurance business through U.S. subsidiaries have exceptionally low effective tax rates. This demonstrates their success in transferring the bulk of their underwriting and investment income offshore to avoid tax under existing mechanisms. Thus, we do not believe that the modifications to section 845 have effectively prevented the stripping of income overseas through the many related party reinsurance transactions that takes place under current law.

When Congress became aware of a similar problem with respect to debt, it addressed the problem by curtailing the amount of tax-favored borrowing by U.S. firms from related foreign parties. As the Joint Tax Committee states in its hearing pamphlet, "a set of definitive rules similar to the earnings stripping rules would probably have a more systematic effect on taxpayers than relying on transfer pricing principles." Thus, we believe the simplest solution would be to adopt a similar approach and defer the deduction as described above.

3. In your testimony, you stated that you were testifying not only on behalf of your company, but also on behalf of a coalition of many of the other largest property and casualty insurers. You also stated during the hearing that your company and the coalition you were representing pay the corporate tax rate of 35 percent. What is your company's EFFECTIVE tax rate? What are the EFFECTIVE tax rates of the companies in your coalition?

Response: The members of the Coalition for A Domestic Insurance Industry generally are subject to the full U.S. corporate income tax rate of 35% on all of their income, except for income derived from investments in lower yielding tax-exempt municipal securities or investments eligible for the dividends-received-deduction. In other words, the effective tax rates of these domestic-based insurers fall below 35% merely because of their willingness to accept lower yields on investments in municipal securities in exchange for the tax exemption on the investment income. Foreign-based companies do not have a similar incentive to invest in tax-exempt securities. Thus, if insurance business continues to migrate abroad because of the competitive tax advantage derived from related party reinsurance, we expect the P&C industry's demand for municipal securities (currently, 15% of all outstanding bonds) will evaporate, thus reducing the available market and price for such securities.

By contrast, as shown in the table below, the effective tax rates of Bermuda-domiciled insurance groups are generally well below the top corporate rate of 35%.

Effective Tax Rates of Members of The Coalition For A Domestic Insurance Industry

Member of The Coalition for A Domestic Insurance Industry	Reported Effective Tax Rate Twelve Months Ended December 2006	Reported Effective Tax Rate Six Months Ended June 2007
AMBAC Financial Group, Inc.	27.6%	25.9%
American Financial Group, Inc,	36.9%	37.1%
Berkshire Hathaway Inc.	32.8%	33.8%
The Chubb Corporation	28.3%	28.6%
EMC Insurance Companies	29.9%	29.8%
The Hartford Financial Services Group, Inc.	23.8%	26.6%
Liberty Mutual	28.0%	31.0%
Markel Corporation	29.1%	30.3%
MBIA Insurance Corporation	28.2%	28.0%
Safeco Corporation	29.0%	28.0%
The Travelers Companies, Inc.	26.5%	24.5%
W. R. Berkley Corporation	29.0%	29.4%
Zenith Insurance Company	35.5%	35.4%

Effective Tax Rates of Select Foreign-Domiciled Insurance Groups

Foreign-Domiciled Group	Reported Effective Tax Rate Twelve Months Ended December 2006	Reported Effective Tax Rate Six Months Ended June 2007
ACE Limited	18.5%	17.9%
Arch Capital Group Ltd.	3.6%	3.4%
Aspen Insurance Holdings Ltd.	19.6%	15.0%
Axis Capital Holdings Ltd.	3.4%	4.3%
Endurance Specialty Holdings Ltd.	5.7%	6.3%
Everest Re Group Ltd.	15.2%	18.3%
XL Capital Ltd.	11.6%	11.4%

4. Given your nearly 40 years experience in this industry, what do you think is the EFFECTIVE tax rate of the property and casualty industry (property and casualty insurers operating in the U.S.)?

Response: As stated in my prior answer, the effective tax rate for U.S. based property and casualty insurers is modestly below the statutory rate of 35%

primarily because U.S. based insurance groups are willing to accept lower yields on investments in municipal securities in exchange for the tax exemption on the investment income. Investing in tax-exempt municipal securities typically lowers a U.S.-based property and casualty insurance group's effective tax rate by two to five percentage points. As you can see from the table above, the average reported effective tax rate for the members of the Coalition for the first 6 months of 2007 was approximately 30%. However, it is important to recognize that not only do we give up yield (and income) in order to report a lower effective tax rate, but we also prepay the taxes on our profits because of the requirement in the U.S. to discount loss reserves in the computation of taxes. Foreign-based groups that engage in related party transactions have no need to lower their yield to reduce their effective tax rate. Nor are they required to discount the loss reserves related to business that is transferred offshore.

5. Do you believe that deferring the loss reserve deduction for related party offshore reinsurance until the loss is paid will keep firms like yours competitive and in a position to remain onshore?

Response: The current law treatment of related-party reinsurance provides an incentive to move insurance capital overseas by allowing foreign-based groups to strip their underwriting and investment profits out of the U.S. tax base to a low-tax or no-tax jurisdiction. This is particularly the case for "long-tail" lines of business where loss reserves are held for a long time and generate substantial investment income. By deferring the loss reserve deduction for related party offshore reinsurance until the loss is paid, the proposal effectively captures the U.S. tax that would have been paid on the investment income (had it not been stripped overseas). Thus, the proposal would reduce current law incentives for offshore groups to enter into related party reinsurance transactions and would help significantly in leveling the playing field. This is essential if domestic insurance companies are to remain competitive in the market for new capital.

6. Would it remove an incentive in instances like this to locate capital in low-tax or no-tax jurisdictions?

Response: The proposal would help to level the playing field and remove the incentive provided by related-party reinsurance to locate new insurance capital overseas. It is important to note that the proposal does not affect, nor was it intended to affect, the ability of companies who provide third party reinsurance to locate in a low-tax or no-tax jurisdiction. Consequently, the proposal would not affect the capacity or market for property catastrophe reinsurance. It would only address those companies who enter into affiliated reinsurance transactions for the purpose of earnings stripping. The related party transactions targeted by the proposal add no additional capacity to the market, but merely shift revenue and reserves from one pocket to another.

Statement of Senator Jim Bunning
September 26, 2007

Thank you, Mr. Chairman.

I am glad we are taking time today to take a closer look at international tax issues as they relate to hedge funds and reinsurance.

There is no doubt that we live in an increasingly global society. Our domestic corporations compete in international markets, and foreign companies compete through subsidiaries here in the U.S. In this environment, Congress must take into consideration how our fiscal policies, like the corporate tax rate, influence and are influenced by the world market.

I commend Chairman Baucus and Ranking Member Grassley for dedicating a significant amount of this Committee's time during the 110th Congress to exploring how low tax jurisdictions affect domestic tax revenue receipts and the U.S. economy.

Surely, the very term "tax evasion" signals to most Americans a fundamental unfairness. As some of our witnesses today will point out, our current tax policy with respect to the reinsurance sector clearly disadvantages certain domestic property and casualty insurers.

I do support closing this loophole, but we must be careful not to overstep and impose tax policy that will make coverage unavailable for common risks.

Beyond closing unfair loopholes, this Committee should challenge the inherent unfairness of the existing tax code to both our domestic corporations and everyday Americans.

I look forward to our witnesses' testimony.

Thank you.

Testimony of U.S. Senator Byron Dorgan before the Senate Committee on Finance Hearing on Offshore Tax Issues

September 26, 2007

Mr. Chairman, I want to applaud you, Senator Grassley and other members of the Finance Committee for holding this series of hearings this year to grapple with complicated tax issues involving U.S. companies and their offshore affiliates and business activities.

The issue of American companies off-shoring good paying U.S. manufacturing jobs, and using overseas tax havens and other tax scams to avoid paying U.S. taxes they rightfully owe, has been around for many years. But today these companies are getting more scrutiny from federal policymakers and Internal Revenue Service (IRS) officials because of the size of their tax dodging and blatant manipulation of our tax laws.

The evidence suggests that we have a serious tax haven problem and it may now be costing the U.S. Treasury tens of billions of dollars every year. That's why I have authored legislation with Senator Levin, S. 396, which we believe will give the IRS new tools to combat offshore tax haven abuses and ensure that U.S. multinational companies pay their share of U.S. taxes.

Curbing U.S. Corporate Offshore Tax Haven Abuses

American taxpayers have a right to be angry when they read or hear news accounts about how corporate taxpayers are shirking their tax obligations by actively shifting their profits to foreign tax havens or using other inappropriate tax avoidance techniques.

A few years ago, this Committee passed legislation, which I supported and is now law, that addresses the troubling problem of corporate inversions that involved a couple dozen U.S. corporate expatriates that reincorporated their headquarters overseas. That behavior was a shameful, unpatriotic tax scam that was shut down by Congress.

However, that legislation hit just the tip of the iceberg. It did nothing to deal with the problem of U.S. companies setting up foreign tax-haven subsidiaries offshore to avoid their taxpaying responsibilities.

Around the time of the debate on corporate inversions, a *New York Times* story hit the nail on the head, suggesting that "instead of moving headquarters offshore, many companies are simply placing patents on drugs, ownership of corporate logos, techniques for manufacturing processes and other intangible assets in tax havens...The companies then charge their subsidiaries in higher-tax locales, including the U.S., for the use of these intellectual properties. This allows the companies to take profits in these havens and pay far less in taxes."

How pervasive is the tax-haven subsidiary problem? Several years ago, the Government Accountability Office (GAO), the investigative arm of Congress, issued a report that Senator Levin and I requested that sheds some light on the potential magnitude of this tax avoidance activity.

The GAO found that 59 out of the 100 largest publicly-traded federal contractors in 2001 -- with tens of billions of dollars of federal contracts in 2001-- had established hundreds of subsidiaries located in offshore tax havens. According to the GAO, Exxon-Mobil Corporation, the 21st largest publicly traded federal contractor in 2001, had some 11 tax-haven subsidiaries in the Bahamas. The same report revealed that the Halliburton Company had 17 tax-haven subsidiaries, including 13 in the Cayman Islands, a country that has never imposed a corporate income tax, as well as two in Liechtenstein and two in Panama. It turned out that the now infamous Enron Corporation had 1,300 different foreign entities, including some 441 located in the Cayman Islands.

But the poster child for offshore tax haven abuses, in my opinion, is a five-story building located on Church Street in the Cayman Islands that thousands of companies call home. According to a very good investigative report published by David Evans with Bloomberg News in the summer of 2004, the Ugland House in Grand Cayman is used as the address for 12,748 companies. In case you haven't seen it, I have carried along a picture of the Ugland House.

A recent study suggests that nearly half of the money U.S. companies earn overseas is accounted for in tax havens like the Cayman Islands. A former Joint Committee on Taxation economist released a study with an extraordinary finding: U.S. multinational companies had moved hundreds of billions of dollars in profits to tax havens in 1999-2002, the latest years for which IRS data was available.

The legislation that Senator Levin and I authored would help the IRS stop these avoidance schemes. Specifically, our legislation denies tax benefits, namely tax deferral, to U.S. multinational companies that set up controlled foreign corporations in tax haven countries. This tracks the same general approach in legislation passed by the Congress and enacted into law that was designed to curb the problem of corporate inversions. Our bill builds upon the good work of your Committee by extending similar tax policy changes to cover this case.

Specifically, our legislation would treat U.S. controlled foreign subsidiaries that are set up in tax haven countries -- <u>but are not engaged in a real and active business</u> -- <u>as domestic companies for U.S. tax purposes</u>. In other words, we would simply treat these companies as if they never left the United States, which is essentially the case in these tax avoidance motivated transactions.

The bill's list of specific tax haven countries subjected to the new rule is based upon previous work by the Organization for Economic Cooperation and Development. However, our legislation does give the Secretary of the Treasury the ability to add or remove a foreign country from this list in appropriate cases. We also give businesses until December 31, 2008 to restructure their tax haven operations if they so choose.

As I mentioned, our legislation effectively ends the deferral tax benefit for U.S. companies that shift income to offshore, inactive tax haven subsidiaries. This means, for example, that:

- Any efforts by a U.S. company to move profits to the subsidiary through transfer pricing schemes will not work because the income earned by the subsidiary would still be immediately taxable by the United States.

- Likewise, any efforts to move otherwise active income earned by a U.S. company in a high-tax foreign country to a tax haven would cause the income to be immediately taxable by the United States.

- Under this bill, companies that try to move intangible assets – and the income they produce – to tax havens would be unsuccessful because that income would still be immediately taxable by the United States.

The Joint Tax Committee says this legislation will prevent these companies from draining nearly $15 billion in revenues from the U.S. Treasury over the next decade.

But let me be very clear about one thing. This legislation, like other legislation I have been working on for many years that deals with runaway U.S. manufacturing plants, does not take a shotgun approach with respect to ending the U.S. deferral tax break. This proposal, and other proposals I have authored, would not repeal tax deferral in all cases.

In fact, the Dorgan-Levin tax haven legislation will not adversely impact U.S. companies with controlled foreign subsidiaries located in tax havens, if they are doing legitimate and substantial business. The legislation expressly exempts a U.S.-controlled foreign subsidiary from its tax rule change when almost all of its income is derived from the active conduct of a trade or business within a tax haven country.

It's grossly unfair to ask our Main Street businesses to operate at a competitive disadvantage to large multinational businesses simply because our tax authorities are unable to grapple with the growing offshore tax avoidance problem. It is also outrageous that tens of millions of working families, who pay their taxes on time every year, are shouldering the tax burden of large profitable U.S. multinational companies using these tax haven subsidiaries.

In a recent *International Tax Notes* article, "A Statutory Proposal for U.S. Transfer Pricing", Michael Durst, a former IRS official and now counsel to a prestigious law firm, suggests that, "based on extensive practice, that retaining the current [arm's length pricing] system is not a viable option" for dealing with current transfer pricing abuses and that "a revised ,concededly more "formulary" system…would offer substantial relative advantages." I think he is dead right and I have advocated for a federal formulary apportionment system for multinational taxation for decades.

But until we move in that direction, my proposal with Senator Levin is a simple, straightforward way to deal with transfer pricing abuses in cases that involve U.S. companies parking profits in offshore tax havens.

End the Wrong-headed Tax Subsidy for Runaway Manufacturing Plants

I have worked very hard with Senator Mikulski and a number of our colleagues to end the large ill-conceived federal tax break provided to U.S. companies that close down a U.S. manufacturing plant, fire its American workers and move those good-paying jobs to countries like China.

I have forced the U.S. Senate to vote on my proposal to end this tax subsidy four times since the early 1990s, but the majority in the Senate has said no. As a result, hardworking Americans whose jobs are cut and moved overseas are forced to help foot the bill of companies that move production offshore – a bill which the non-partisan Joint Tax Committee suggests will cost taxpayers $15.5 billion over the next decade. We can no longer afford to ignore this matter. The federal debt is expected to hit $9 trillion at the end of the year and continue climbing to over $11 trillion in just five years.

Our proposal, S. 1284, would end the insidious tax subsidy in the tax code that rewards U.S. firms that move their production overseas and then turn around and import those products back to the United States for sale. When a U.S. company closes down a U.S. manufacturing plant, firing its American workers to move those good-paying jobs to China or other locations abroad, U.S. tax laws allow these firms to defer paying any U.S. income taxes on the earnings from those now foreign-manufactured products until those profits are returned, if ever, to this country. This tax break is not available to American companies that make the very same products here on American soil. So the U.S. company that decides to stay at home suffers a competitive disadvantage -- a disadvantage that our tax laws have helped to create. Multinational companies ought to pay the same taxes that domestic companies pay. At a minimum, U.S. companies that keep their jobs here should not be put at a competitive disadvantage by federal tax policy.

The notion that granting large tax breaks to companies that move their manufacturing operations offshore is good for this country is utter nonsense. Among other things, those who support this fiscal policy claim that shutting down U.S. manufacturing operations and moving them abroad will result in more U.S. jobs and increase our exports.

However, this assertion is not supported by the facts. According to the latest available data, the number of foreign manufacturing affiliates has grown from 7,420 to 8,490, up some 14 percent since 1993. From 1993 though 2004, U.S. companies moved one million manufacturing jobs offshore to their foreign affiliates.

Throughout this entire period, this perverse deferral break has been in effect. Has it resulted in new U.S. manufacturing jobs? No. We have lost some 3.1 million U.S. manufacturing jobs since 2000 alone. Has this misguided tax subsidy resulted in higher exports from U.S. companies to their foreign affiliates, as the proponents of this tax subsidy suggest? No. In fact, imports into the United States from the foreign subsidiaries of U.S. companies more than doubled from $92 billion in 1993 to $203 billion in 2004. And the balance of trade with foreign affiliates of U.S. firms plummeted to a $72 billion deficit in 2004 as compared to $3.4 billion in 1997.

I have described stories on the Senate floor about a number of American companies that have moved production overseas. These companies include: Huffy bicycles and Radio Flyer little red wagons moved to China; Samsonite went to Mexico and then China; Levi's are now made all over the world, everywhere except in the very country that invented them; Maytag now makes appliances in Mexico and Korea; and Fruit of the Loom moved to Mexico. This tax deferral break given to companies like Radio Flyer or formerly to Huffy bicycles is not available to American companies that make the very same products on U.S. main streets.

In a similar refrain, let me share with you something from a recent article that describes the problem relating to manufacturing jobs so well. This story was part of a recent Washington Post article regarding a small town in North Carolina.

> " 'We didn't see it coming,' the furniture man grimly declared. Michael K. Fugan once ran Henredon Furniture Industries, which operated a plant in Spruce Pine, a former mining town in the rugged mountains in the western part of the state.
>
> There the company made hand-carved wooden bedroom furniture, once employing more than 1,000 people. Many lacked high school diplomas and some were illiterate, yet the factory provided a way for these workers to support families and to acquire modest homes and cars.

> It paid roughly $14 an hour, plus health and pension benefits. Henredon's four-poster beds retailed for about $5,000 in the early 1990s, Dugan recalled. A few years later, similar models started showing up from the Philippines for less than $2,000. Now they can be found for $799, produced by workers in southern China who earn as little as 40 cents an hour.
>
> Henredon first trimmed its workforce. Three years ago, it shut down the plant, eliminating 350 positions…For 26 years, Phillip Wilson worked at Henredon as a master carver. Now, on most days, he wakes before dawn and drives to his new job – the 5:30 a.m. shift as a prison guard... his pay down 15 percent, forcing him into a second job at a used-appliance store to make ends meet."

Still we run into stiff opposition from many U.S. multinational companies, their lobbyists and some policymakers who claim our proposal would impede the ability of U.S. firms to compete and grow in the global economy. That's hogwash. To hear the proponents of cutting corporate taxes, one might be lead to believe that somehow U.S. companies are struggling to compete in the international arena. But that is simply not the case.

My proposal with Senator Mikulski certainly does nothing to hinder U.S. multinationals that produce abroad from competing with foreign firms in foreign markets. The legislation we have introduced is carefully targeted; it ends the deferral tax break only where U.S. multinationals produce goods abroad, and, then ship those products back to the U.S. market.

Once again, I'd like to remind everyone that the tax experts with the Joint Committee on Taxation estimate that this pernicious tax break will cost U.S. taxpayers some $15.5 billion over the next decade. It is no wonder that the powerful lobby for the largest U.S. multinational firms has fought to keep this tax loophole fully intact.

Given our exploding deficits and debt, I hope the Senate Finance Committee will pass this initiative to shut down this loophole. But if not, I will bring this proposal to the Senate floor with Senator Mikulski and others again and again until this wrong-headed tax subsidy is finally repealed.

I understand that some U.S. companies will still choose -- with or without this tax subsidy -- to dislocate thousands of workers in America in search of cheaper labor, lax regulation and greater profits abroad at whatever the cost. They will be free to do so. But at least U.S. taxpayers will not be asked to provide billions of dollars in tax subsidies for those who do.

End Tax Benefits for Abusive Foreign Cross-Border Leasing Transactions

In S. 554, I authored a proposal that would put a death nail in the heart of abusive cross-border foreign leasing transactions. Specifically, this provision adjusts the effective date for the application of the JOBs Act of 2004's anti-leasing abuse prohibition. The loss limitation rules would apply to leases with foreign entities, regardless of when the lease was entered into.

This provision relates to one of the most scandalous tax abuses I can remember in recent years. A few years ago, PBS's Frontline program aired stories that uncovered massive tax shelter scheme dealing with cross-border leasing abuses, known as Lease-In/Lease-Out Transactions (LILOs), and later known as Sale-In/Lease-Out Transactions (SILOs). The stories discussed how city accountants in Germany and other European countries had generated large cash payments for selling or leasing their streetcars, water purification plants, sewage systems, town halls, rail systems and school buildings to large U.S.

corporations that artificially generated large rental or depreciation deductions to pay little or no U.S. taxes. This Committee is very familiar with this issue.
With Rev. Ruling 2002-69 and by regulation, the IRS challenged the rental and interest deductions generated by LILOs. This effectively put an end to the use of tax loss-creating LILO transactions. However, the industry regrouped and replaced LILOs with SILOs, and, then asserted that the IRS rulings did not cover these "unique and different" transactions.

One of the worst SILO cases I am aware of involves Wachovia Bank (formerly First Union Bank), which reportedly entered into a SILO transaction involving its purchase of sewer pipes in Bochum, Germany. Under the transaction, Bochum sold its underground sewer pipes to Wachovia for $500 million. The city then immediately leased those pipes back, thus retaining use of its sewer system and repaying the lease over a period of many years with the proceeds from the "sale." In return, Bochum was immediately paid a $20 million fee. Wachovia would eventually get its money back – absent the fee, and the Bank reportedly generated about $175 million in tax savings coming primarily from depreciation deductions over time.

From the standpoint of the entities involved in these deals, there was little or no financial risk. When the deal was closed, the tax-exempt indifferent entity, say a foreign municipality, continued to use the property it "sold" but was leased back under the agreement and the U.S. taxpayer now gets the following tax benefits:

1) <u>Large depreciation deductions</u> that are worth more than the "payments" made to "purchase" the property and the fee they pay to the tax indifferent party;

2.) <u>Amortization of transaction costs</u> (cost of setting up the deal) over the period of the deal; and

3.) <u>Interest deductions</u> for the loans the taxpayer used to "purchase" the property.

In 2004, Congress limited the tax benefit available in these transactions by allowing U.S. taxpayers to take tax breaks only up to the amount of income recognized on a year-by-year basis under the leasing agreement. However, there are some foreign leasing transactions entered into prior to March 12, 2004, where the lessee is a foreign tax exempt entity that is not affected by this law change. We should close this international tax scam completely. This means that large U.S. companies that already had completed foreign SILO transactions will siphon the Treasury General Fund – and therefore the American taxpayers – of an estimated $4 billion over the next decade. That result can not be allowed to stand and I look forward to working with the Committee to finally pull the plug on these unbelievable tax scams.

In the words of Cologne's city accountant, "After all, the Americans should know themselves what they do with their money. If they subsidize this kind of transaction, we gratefully accept."

In conclusion, Mr. Chairman and members of the Committee, I look forward to working with you to stop those profitable U.S. multinational companies that benefit from our legal system, our national defense and other government protections, but do not believe they should contribute their fair share of taxes to keep this country strong.

Congressional Research Service

Statement of Jane G. Gravelle
Senior Specialist in Economic Policy
Congressional Research Service
Before
The Committee on Finance
United States Senate
September 26, 2007
on
Offshore Tax Issues

Mr. Chairman and Members of the Committee, I am Jane Gravelle, a Senior Specialist in Economic Policy in the Congressional Research Service of the Library of Congress. I would like to thank you for the invitation to appear before you today to discuss investments of educational institution endowments and off-shore funds.[1] At issue is the use of offshore feeder corporations that allow tax exempt investors, including educational institutions, to avoid the unrelated business income tax. Although I discuss the consequences of options and approaches, please note that the Congressional Research Service takes no position on legislative options.

Educational institutions have significant endowments, totaling at least $340 billion in 2006; these endowments have been growing rapidly, and earn a relatively high rate of return. Their overall return of 15.3% in 2006 translates to earnings of $52 billion, earnings that are generally tax exempt. Forgone revenue from not taxing that income at a 35% rate is larger than the total tax expenditure for charitable giving to education.

Endowment assets are not evenly distributed among higher education institutions: Harvard, with the largest endowment, had 8.5% of the total, the top five institutions ranked by endowment had 25%, the top 20 almost half, and the 62 institutions with over $1 billion in assets account for two thirds.

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[1] Data reported in this testimony, unless otherwise specified, are taken from a CRS Memorandum prepared for Senator Baucus and Senator Grassley, by Jane G. Gravelle, August 20, 2007, which is referenced here with their permission. Those sources in turn included National Association of College and University and Business Offices, 2006 (NACUBO) Endowment Study, [http://www.nacubo.org/x2376.xml]; *The Chronicle of Higher Education; The Chronicle of Philanthropy: Endowments at Non-Profits Organizations, Year Ending June 30, 2005*; John Hechinger, "When $26 Billion is Not Enough," *Wall Street Journal*, Dec. 17, 2005; U.S. Department of Education, National Center for Educational Statistics, College Opportunities Online Locator [http://nces.ed.gov/ipeds/cool/index.aspx]; Lynne Munson, "Robbing the Rich to Give to the Richest," *Inside Higher Ed*, July 26, 2007, at [insidehighered.com] and various annual reports.

Educational institutions' endowments have a significant and growing share of their portfolios in hedge funds and private equities, which are likely to be heavily invested in offshore funds. Overall, weighted by institution (the institutions share's are averaged), 22% of endowment portfolios in 2006 were in these hedge fund and private equities investments, up from 14% in 2002. The share would be much larger if the percentage were weighted by endowment size because larger funds have larger shares. Funds over a billion dollars have 28% in these funds (averaged across institutions), and the total percentage weighted by assets would presumably be larger. It is difficult to obtain data on an institution by institution basis, but of the top ten funds, in 2005 Columbia University had a 45% share, while Princeton and Yale had 38% and 37% respectively. The most heavily endowed four year liberal arts colleges also had significant shares (where data were available): two of the top seven, Amherst and Smith, had shares over 40% and two, Grinnell and Williams, had shares over 30%.

Data on the share in offshore investments is not available but one study indicated that Duke University had 75% of their hedge funds in offshore investments.[2]

Two possible revisions of current treatment to prevent tax exempt educational institutions from avoiding the unrelated business income taxes by investing in offshore funds are often discussed. The first would be to restrict the use of offshore investments, which would lead to additional taxes collected. It could also cause a shift in investments.[3]

An alternative approach would be to leave the current treatment of these institutions' investments in place but address whether these institutions should be doing more, or be required to do more, with their endowments to pursue objectives for the public good, such as making education more affordable, given the tax advantages granted. Indeed, when questioned by a reporter about the use of offshore entities, a spokesman for Duke University stressed the use of endowments for financial aid and research.[4] The remainder of this discussion addresses how the tax-preferred earnings from endowments are used and what approaches might be considered to direct these resources to objectives such as more affordable tuition.

Endowments are currently earning high returns, with most of that return being used to increase the endowment rather than being spent. While the average return in 2006 was 15.3% the payout rate was 4.6%, weighted by institution. Educational institutions with large endowments earned the highest returns on average; payout rates were about the same across institutions with different endowment sizes. Again, while it is difficult to obtain institution level data, the three institutions with the largest endowments, Harvard, Yale, and Stanford, earned returns of around 20% (in 2004-2005) but paid out 4.5% (in 2003-2004). Out of the ten institutions with the largest endowments, only three paid out more than 5%, and out of eight private institutions, only one paid out more. Out of the top twenty, only five paid out more than 5%. Over the two year period Harvard's endowment grew by 30%, while Yale's

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[2] Maximilian M. Haag, "Hedge Fund Investments of Private Foundations and Educational Endowments," *Tax Notes Today*, November 15, 2005.

[3] Economic theory suggests that there would be some shift out of investments, but the magnitude is uncertain. At least one expert, Leon Metzger, is quoted as saying that a major impact is unlikely. See Stephanie Strom, "Nonprofits Face Threat to a Tax Loophole," *New York Times*, May 16. 2007.

[4] Stephanie Strom, "Nonprofits Face Threat to a Tax Loophole."

and Stanford's grew by 40%. All of the endowments of private institutions in the top ten grew by at least 20%.

While the top ten four-year liberal arts colleges had lower returns, most of them also had relatively low payout rates relative to returns, and significant growth in their endowments.

Institutions indicate that they limit payout rates in part to cushion shocks. This is a standard practice to account for years of losses. However, despite covering a recession with significant market losses, returns remained, on average, well above payout rates over the past five and ten years. Many institutions with large endowments have very high endowments per student. Per undergraduate student, Harvard, Yale and Princeton have between \$2 and \$3 million; per total student they have between \$1 and \$2 million. MIT, Stanford and Rice have endowments per undergraduate exceeding \$1 million and endowments per student exceeding \$500,000. All of the private institutions in the top 20 have endowments per student well over \$100,000.

The ten liberal arts colleges had large endowments per capita as well: seven of the ten had over \$500,000 and the remaining three around \$100,000.

If an approach to addressing the offshore shelter issue is to permit tax benefits but to target them towards making tuition more affordable, an issue to consider is the size of endowments relative to tuition increases and financial aid. While endowments were growing, these institutions with large endowments continued to raise tuition in most cases by 5% or more. If Harvard, Yale, Princeton, MIT or Stanford had paid out 1/10 of 1% of their endowment for undergraduate tuition, undergraduate tuition increases would have been unnecessary to maintain the budget. In none of the 20 institutions with the largest endowments were tuition increases larger than 7/10 of a percent of the endowment, so that all of these institutions could have avoided undergraduate tuition increases by increasing their payout ratio by less than one percentage point. Similar magnitudes applied to the ten liberal arts colleges (although Berea is an essentially tuition free college). Of the 62 institutions with over a billion dollars in endowments, their 6.8% tuition increase averaged 9/10 of 1% of the endowment.[5]

Harvard's institutional undergraduate aid was less than ½ of a percent of the endowment, so that by paying out an additional ½ of a percent, they could have doubled aid. The same is true of Stanford and Princeton, while Yale's undergraduate aid was 1/3 of 1% of the endowment. Many other schools in the top 20, especially private schools could have significantly increased their undergraduate aid with a small additional payout from the endowment, while still permitting endowments to grow well in excess of real growth. Out of the ten liberal arts colleges, six had institutional aid of less than 2% of endowment, and could have significantly increased their aid with a small increase in payout. For the 62 institutions with over \$1 billion in endowments, total aid was 2.85% of total endowments.

In general, therefore, it appears that the main effect of the high returns on endowments, for those institutions with large endowments, is to increase the size of the endowment.

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[5] Note that some donations have provisions directing the use of funds for specific purposes, such as stadiums and professorships.

There are a number of policy options that might be alternatives to a restriction of these offshore investments by educational institutions. Private foundations are required to pay out a portion of their assets, and are subject to a minimum rate of 5%, which leads to an average payout of 7%. The overall payout ratio on educational institutions' endowments fall below this level. One option would be to require a payout rate; or to require a payout rate (or a higher rate) for institutions as long as their per student endowment is above a fixed amount. Alternatively, one could relate the payout rate to the earnings rate so as to preserve the real value of the endowment and perhaps some small growth, but not allow it to grow so rapidly. Another option, if the public policy concern is about affordable education, would be to impose a tax on the endowment for schools with tuition increases over a pre-determined threshold.

Congressional
Research
Service

Memorandum October 30, 2007

TO: Senate Finance Committee
Attention: Ryan Abraham

FROM: Jane G. Gravelle
Senior Specialist in Economic Policy
Government and Finance Division

SUBJECT: Follow-up Questions to Offshore Tax Issues Hearing

This memorandum is in response to your request for answers to follow-up questions for the record relating to the hearing on offshore tax issues, September 26, 2007

Questions from Senator Hatch

Dr. Gravelle, you mentioned in your testimony two possible revisions to the current tax treatment to prevent tax-exempt educational institutions from avoiding the unrelated business income tax by investing in offshore funds. Can you outline these specifically and tell us whether these ideas have been introduced in the Congress as legislation?

Is there a minimum amount of annual payout for educational endowments? Also, how do the payout rates for these endowments compare with that of charitable foundations?

Response

I referred to two possible general approaches if the Congress were to legislate in this area. The first would be to impose the unrelated business income tax (UBIT) on earnings from offshore firms. Currently, debt-financed investments are subject to the these taxes. In the case of partnership investments, the flow through of attributes results in an imposition of the UBIT. In the case of domestic corporations there is no flow through, but a tax is imposed at the corporate level. Offshore investments use corporate blocker firms that are structured to avoid corporate tax but prevent the flow through of attributes. Although provisions to subject these offshore earnings to tax could be structured in different ways, one approach would be to provide look through rules for investments in foreign corporations. The provision could be made broader by applying to all corporations or narrower by applying only to foreign corporations organized in tax havens.

To my knowledge there are no legislative proposals to require the UBIT on offshore investments. There are proposals to extend the exclusion from UBIT to leveraged investments in partnerships; presumably the objective of this provision is to place domestic investments on the same footing as offshore ones. This change is included in H.R. 3105 (Congressman Levin) and in the tax reform proposal, H.R. 3970, unveiled by Chairman Rangel on October 25.

On average, educational institutions have been earning very high returns, fueled in part by untaxed, high-yield hedge fund and private equity investments, while continuing traditional, and relatively low, payout rates from their endowments. Endowments have been growing rapidly. An alternative approach is to continue to permit these tax favored returns but to focus on the use of them for charitable and public policy objectives. An objective that readily comes to mind is the affordability of education. Currently, there is no required payout rate for these endowments as there is for foundations.

Several approaches were discussed in my memorandum for the Chairman and Ranking Member of the Committee:

- Expanding reporting of information on endowments with the expectation that publicity would induce educational institutions to increase distributions, slow tuition growth, and/or increase financial aid.

- Require a minimum distribution, perhaps at the 5% rate of foundations. The payout requirement could be capped so the endowment does not fall below its original value. The payout requirement could also be restricted to institutions that have a large endowment per student (measured by either all students or all undergraduates),

- Require a minimum distribution that is triggered by the level of return, for example, return in excess of inflation and some given real growth rate (which could be zero) would be required to be distributed.

- Impose a tax on endowments of institutions that raised their tuition above the inflation rate. As with a payout requirement, this provision could be restricted to institutions with large endowments. It might be necessary to include room and board in the total to prevent substitution of costs.

According to research by Ms. Munson, the average payout rate for foundations is 7%. The payout for educational institutions from their endowments is about 4.5%.

Questions from Senator Roberts

I believe that both you and Ms. Munson suggested that five percent could be a starting point for a payout requirement, consistent with that required of private foundations. Ms Gravelle, you have also suggested an option that would cap the requirement distribution so that it would not exceed the earnings from the endowment. If such a cap were in place, would it be sufficient to ensure the adequate growth of the endowment and maintain the purchasing power of the initial donation?

Response

A rationale for providing a cap on distributions is to address endowment agreements that require preservation of the principle, which would restrict distributions that caused the endowment to fall below its original value. Such a cap would not guarantee the maintenance of purchasing power, because, while the nominal value of the endowment would be retained, the purchasing power would fall in real terms. To ensure that the required distribution did not reduce the purchasing power, the pay-out requirement would need to be capped so that payout did not reduce the endowment below its value increased by inflation. For educational services, this inflation rate is argued to be higher than the general inflation rate.

In considering this issue, nominal growth to preserve purchasing power should be differentiated from real growth. Real growth in aggregate endowments does not necessarily have to come from earnings, since continual donations are made. In a steady state environment where donors provide a constant share of incomes, new donations should be adequate to allow steady state growth.

On average and based on observations of returns and additional contributions, endowments of most educational institutions would continue to grow in real terms even with a 5% payout requirement and without considering new donations.

Statement of the Association of Bermuda Insurers and Reinsurers

Donald Kramer, Chairman and CEO of Ariel Reinsurance Company

Informational Hearing -- Offshore Reinsurance
United States Senate Finance Committee

September 26, 2007

My name is Donald Kramer, I am Chairman and CEO of Ariel Reinsurance Company, and I am pleased to speak to you today on behalf of the 23 members of the Association of Bermuda Insurers and Reinsurers (ABIR). I am an American citizen with a Bermuda work permit allowing me to live and work in Bermuda. I have been the CEO of Ariel Re since it was created late in 2005 in the wake of the estimated $70 billion in U.S. insured losses following the Hurricane trio of Katrina, Rita and Wilma. In 1993, I was the original CEO of Tempest Re, a Bermuda reinsurer created following Florida's devastating Hurricane Andrew. As with the 2005 hurricanes, in 1992 following Andrew, United States' homeowners and businesses were finding it difficult to find property insurance as the insurance market adjusted to the unprecedented size and scope of that hurricane. As a result, I now have experience with two Bermuda start-up reinsurers formed to meet U.S. market needs. I also have experience running a U.S. reinsurance company.

We welcome this opportunity to discuss the importance of reinsurance to the insurance industry and the American consumer. Insurance has become a global business. And reinsurance across borders plays a vital role in the efficient operation of the global insurance market. Bermuda is one of the world's leading insurance centers—along with New York, London, and Zurich—and is recognized worldwide for particular expertise in reinsurance.

<u>The Importance of Reinsurance</u>

Businesses, homeowners and others seek property and casualty insurance to protect themselves against the substantial risks they face. That protection needs to be sold at rates which reflect the actual risk insured. Reinsurance allows the insurance industry to transfer risk, helping to make this coverage more affordable. Reinsurance facilitates the efficient operation of the global insurance market by moving risk to insurance centers with special underwriting expertise. Reinsurance also allows capital to be pooled so that a reinsurer can quickly respond to changing market conditions by making that capital available to sell and support insurance coverage in varying locations or for classes of business where the market need is greatest.

Reinsurance is used extensively within the U.S. property-casualty industry. A substantial percentage of U.S. insurance companies cede more than half of the gross premiums they write to reinsurers. Affiliate reinsurance is used routinely within U.S.-based insurance company groups, for valid non-tax business reasons. Affiliate reinsurance provides an efficient way for a related group of companies to pool risks and manage them more efficiently. It enables affiliates to write additional business without having to raise additional capital, and permits affiliates to underwrite larger risks than their capital would otherwise allow. Insurance rating agencies recognize the value of affiliate reinsurance, and often take it into account when analyzing the claims-paying rating to be assigned to the U.S. affiliate.

The Basic Reinsurance Transaction

Reinsurance is a contractual arrangement that transfers risk. The insurance company that issued an insurance policy and now seeks to transfer its risk is known as the ceding company, while the company that assumes the insurance risk is the reinsurer. In the cross-border context, the ceding company may be a U.S. company, and the reinsurer a non-U.S. company. Through reinsurance, the parties agree to share premiums, losses, and loss expenses arising out of the original insurance covered by their agreement.

When an insurance company cedes business to a reinsurer, the ceding company pays a premium to the reinsurer, while the reinsurer generally pays the ceding company a commission. This commission, known as a ceding commission, compensates the ceding company for its acquisition and operating costs and reflects the anticipated profitability of the business – the more profitable the business is expected to be, the higher the ceding commission the primary insurer will demand and the reinsurer will be willing to pay. The ceding commission is generally paid in the same year premiums are received from the policyholder and paid over to the reinsurer. The ceding commission is taxable as income to the ceding company, which is subject to the same U.S. tax on its worldwide income as any other U.S. firm would be.

The United States requires a large amount of reinsurance capacity, a substantial part of which is supplied by non-U.S. reinsurance companies. More than half the reinsurance purchased each year by U.S. insurance companies is from non-U.S. reinsurers.[i] For certain classes of business, the non-U.S. proportion is even greater. For example, two-thirds of the reinsurance to protect insurers of homes and businesses from hurricanes and earthquakes (property catastrophe reinsurance) comes from non-U.S. reinsurers. The tragedy of September 11, 2001 highlighted the importance of non-U.S. insurance and reinsurance to the U.S. market. More than 60 percent of the World Trade Center insurance claims were paid by non-U.S. insurers and reinsurers. Hurricane Katrina also reinforced this point, since approximately 50 percent of the insurance and reinsurance claims paid for Hurricane Katrina losses came from non-U.S. reinsurers. Bermuda's carriers alone contributed 24 percent of that total.[ii]

Background on ABIR

The ABIR membership includes only the global insurers and reinsurers domiciled in Bermuda (not the captives) and our members collectively wrote at 2006 year end $56 billion in premiums with a surplus base of $67 billion.[iii] Bermuda's insurers are specialists in business that is typified by large sized, infrequent claims. This business is highly volatile and many U.S. publicly-traded insurers have shied away from it because of the problems the state regulatory system imposes on insurers trying to quickly adjust rates or coverage terms to meet new underwriting goals.

There is no one Bermuda insurer business model. According to several published reports on publicly traded companies, approximately 65 percent of our business is reinsurance; 35 percent is insurance; 57 percent is property insurance; 54 percent is North American and 28 percent is European in origin.[iv] The United States is the world's largest insurance market so it is not surprising that the majority of our business comes from North America. But ABIR members generate business income from more than 100 countries around the world. It is incorrect to describe us as a market that solely serves the United States. Although our companies are smaller than their older European and American competitors[v], Bermuda is now a major global reinsurance center. That wasn't always the case.

Reinsurance in Bermuda

In the mid-1980's, U.S. businesses and consumers faced a shortfall in liability insurance coverage. Everyone from local governments, to doctors and lawyers, to day care centers, to Fortune 1000 companies, to condominium associations, faced problems in finding and affording insurance coverage due to market shortages following unexpected losses that affected the U.S. liability insurance sector. In its scope it was the biggest insurance market crisis of the 20th century. Bermuda's ACE and XL (Bermuda's two largest insurers) were formed by businesses that pooled their resources to form new insurers that would sell specially crafted, excess liability insurance products to meet their collective insurance needs. Since Bermuda was already the home of a significant captive[vi] insurance market, the regulatory and operational infrastructure was in place to serve this new market and thus these Fortune 1000 businesses were comfortable with Bermuda as their insurers' chosen home. Most importantly, the Bermuda regulatory system allowed companies to be formed, licensed, and writing insurance in a matter of a few months, which was critical to respond to the insurance crisis in a timely manner.

The United States has experienced four such insurance market crises in the last 30 years. In each case incumbent insurers in the U.S. and Europe pulled back to rebuild their capital bases after unexpected shock losses or sustained deterioration in underwriting results. In turn, capital markets raised billions of dollars to finance the creation of new competitors to provide consumers with needed insurance coverage in light of these new market opportunities. These four waves of company formations in Bermuda followed: 1) the mid-1980's liability crisis; 2) Hurricane Andrew and the property insurance crisis of 1992-1994[vii]; 3) the World Trade Center tragedy and the ensuing financial market turmoil in 2001 and 2002; and 4) the hurricane insurance market crunch following Katrina, Rita and Wilma in 2005[viii]. In my work with Tempest Re and Ariel Re I have personal experience about the important role Bermuda insurers play in meeting the critical needs of U.S. and European businesses and consumers in two of these periods of insurance market shortages.

Bermuda's Economic Contribution to the United States – Insurance Coverage and Jobs

Our economic contribution to the United States is significant. Our contribution is multi-faceted including catastrophe claims payments, other insurance and reinsurance payments and job creation. ABIR members paid approximately $2 billion in losses from the 2001 U.S. terrorist attacks, approximately $5 billion in claims from the Florida quartet of hurricanes in 2004 and approximately $17 billion in claims from the 2005 Katrina, Rita and Wilma events. Collectively in just six years, these carriers paid more than $25 billion in catastrophe claims alone to their U.S. customers. [ix]

Let's put these U.S. catastrophe insurance payments in perspective. According to an economic analysis provided to ABIR by GSP Consulting (a Pennsylvania-based economic consulting firm)[x], the Bermuda carriers' 2005 hurricane claims payments provided enough funds to rebuild 45,000 homes in Louisiana, 24,000 homes in Mississippi and 12,000 homes in Florida. Bermuda's economic contribution covered 32 percent of the home rebuilding needs in the areas affected by Katrina, Rita and Wilma. In addition, looking at claims payments for rebuilding businesses and their lost income, Bermuda's insurers paid an estimated 10 percent of the total (federal government plus insurance industry payments) business recovery assistance provided to Louisiana and Mississippi. Our funding helped return more than 9,000 employees to work in Louisiana and nearly 5,000 employees to work in Mississippi. The question you would logically ask, is where would these consumers be, where would the U.S. economy be without the significant contribution of these Bermuda insurers to the U.S. economy? The answer is that fewer people would have been able to return to their homes and the state economies would have declined further or stagnated longer.

Here's another example. Bermuda's insurers and reinsurers are also leading providers of U.S. crop insurance. According to GSP Consulting, in 2005 Bermuda insurers and reinsurers accounted for nearly 57 percent of total net premiums written in the U.S. crop insurance and reinsurance market. Iowa's farmers in 2003 reported more than $237 million in crop insurance claims. The average Bermuda company wrote $36.5 million in premium in Iowa in 2005 – enough to cover more than 3,150 farms. In total Bermuda companies may insure more than 50,000 Iowa farms. In Kansas, the average Bermuda firm may insure as many as 2,290 farms and in total there may be 36,635 farms insured through Bermuda companies. Bermuda based companies write more than $1.6 billion in crop insurance premium.

Employment Statistics

Fourteen ABIR members have U.S. subsidiary corporations to conduct additional insurance or reinsurance operations in this country. These companies are fully subject to U.S. corporate income taxation.[xi] Our membership employs 17,000 people around the world, including 1,700 in Bermuda, 9,600 in the United States and 4,700 in Europe.[xii]

U.S. employees of ABIR are distributed around the country, with large numbers located in New York, Connecticut, Pennsylvania, Georgia, Delaware and California. GSP

Consulting estimates that these employees in turn lead to the employment of an additional 95,000 people as service providers, everything from claims adjusters, to brokers, to investment managers, to risk consultants, to lawyers, accountants, actuaries, information technology managers and others. We believe ABIR members are net job creators in the U.S. economy. Protectionist tax measures targeted at these U.S. operations will likely lead to a reduction in U.S. insurance industry employment.

Why Bermuda

We are always asked: why are we in Bermuda?[xiii] Having been the CEO of one U.S. insurance company and two Bermuda companies I'm in a good position to answer that question. First and foremost, we are in Bermuda because we can quickly deploy our capital, form a company, get licensed and write insurance. No other jurisdiction does this as well as Bermuda. The insurers then deploy their capital to meet critical market needs whether in the United States, Asia, Latin America, Europe or the rest of the world. Capital is not trapped in regulatory frameworks that limit the insurer's flexibility to exit and enter markets. We are not subject to regulatory price controls nor coverage mandates.

In the mid-1980's, concurrently with the formation of ACE and XL, capital providers attempted to create a U.S. liability company called the American Slip. After three years or so of trying the company was not able to build its operations because it was unable to secure sufficient state licenses to conduct business on a countrywide basis and therefore recognizing that the market opportunity was gone, the effort was abandoned. The U.S. insurance regulatory system, with its 50 state licensing requirements, burdensome and often contradictory state rules and a focus on regulatory requirements unnecessary for a wholesale insurance market (which is targeted to sophisticated commercial insurance and reinsurance customers), is a major impediment to capital formation of insurance companies in the United States today.

Moreover, Bermuda is one of the world's centers of expertise in reinsurance. If you need reinsurance you go to the markets in New York, London, Zurich and Bermuda looking for coverage. Bermuda is now the leading center of excellence with regard to property catastrophe reinsurance (reinsurance that pays for damage to homes and businesses from hurricanes and earthquakes) and catastrophe related high layers of excess liability insurance (insurance for protection against lawsuits from a variety of causes that based on the number people or businesses involved can result in hundreds of millions of dollars in claims). These are volatile classes of business and in Bermuda we developed the underwriting talent and the information technology that allows us to successfully underwrite these classes of coverage. The underwriters in Bermuda have formed a center of expertise and the synergies that flow from that community have attracted additional business activity.

As a result, Bermuda has become a principal bulwark in the financial support available to the United States for catastrophic risks. Today, Bermuda provides U.S. businesses and homeowners with 40 percent of the market capacity for property catastrophe reinsurance;

for Florida this number is 50 percent. Our ability to compete fairly to provide this capacity as efficiently as possible helps stabilize the market for these volatile exposures, ultimately reducing costs, stimulating growth and development, and helping communities rebuild when necessary.

U.S. Taxation

Under longstanding U.S. and international tax principles, a foreign-based reinsurer that derives income abroad from reinsuring risks originating in the United States is not subject to U.S. federal income tax in the United States. Cross-border reinsurance with a foreign reinsurer, whether affiliated or unaffiliated, moves the risk of loss to a non-U.S. entity. Income on premiums associated with that risk is earned and taxed abroad where the risk now resides. Similarly, any losses will be borne by the non-U.S. entity. It is well-established that when affiliated parties enter into the same economic arrangement as unaffiliated parties, the transaction will be respected for tax purposes. The U.S. Treasury has ample authority under Section 482 and the recently strengthened Section 845 to assure that cessions between affiliates are made on an arms-length basis, which is the internationally accepted standard that the United States has long championed for such cross-border transactions.

We have heard our critics say that we are in Bermuda because we want to avoid U.S. taxation. That is simply incorrect. All premiums ceded to Bermuda reinsurers or paid by U.S. businesses when they directly buy insurance from a Bermuda based insurer is subject to the U.S. insurance excise tax, a tax which is paid regardless of whether the reinsurance ultimately results in a profit or a loss. All affiliated reinsurance transactions between a U.S. insurer and its Bermuda affiliate are, of course, subject to the reinsurance excise tax. In addition, our U.S. subsidiaries pay U.S. income tax on their worldwide income.

Some have suggested that affiliate reinsurance is comparable to borrowing among affiliates. Reinsurance differs significantly from these transactions, however. Bona fide reinsurance, unlike earnings stripping, involves the true transfer of risk. Transferring risk transfers the losses as well as the gains associated with that risk. Significantly, reinsurance transactions must pass muster with State insurance regulators. Earnings stripping, by contrast, is a debt/equity problem – when capital is supplied by an affiliate, whether it takes the form of debt or equity may have little real economic consequence. The tax consequences of risk transfer, on the other hand, should follow the economics. Regulation requires the price in a reinsurance transaction to be an arm's length price; therefore, these transactions must be respected for tax purposes.

Impact on U.S. Consumers

Increasing these taxes will increase the costs for U.S. businesses and consumers. Increased taxes will increase prices and reduce the availability of coverage and competition in insurance markets, worsening capacity shortfalls and escalating insurance prices unnecessarily. Business owners in Kentucky and New York, and homeowners in

Florida, Louisiana and Mississippi will pay more for their insurance. Farmers in Iowa, Kansas, Montana and North Dakota may have trouble finding a choice of crop insurers. Increased tax obligations - simply put - directly reduce an insurance company's capital and that in turn reduces the amount of insurance coverage that can be provided by that insurer. As you know, today in the U.S., homeowners from Massachusetts to Texas are finding it difficult to buy insurance to protect against hurricanes. The Florida Consumer Action Network, which has some 30,000 members, recently sent a letter to Senators Bill Nelson and Mel Martinez. Here is an excerpt from that letter:

> *"We urge you to be wary about proposed revenue raising amendments that promise the US government more tax revenue at the expense of non-US reinsurers. We believe that this action will increase reinsurance costs for Florida consumers and reduce the capacity from non-US reinsurers – thus increasing insurance costs for Floridians. . . . It's not a good deal and these amendments should be exposed as protectionist measures by US insurers seeking to grab more business for themselves by increasing taxes on their non-US competitors – taxes ultimately paid by Florida consumers."*
>
> Bill Newton, Executive Director
> Florida Consumer Action Network represents 30,000 members. (7/6/07 letter to Sen. Bill Nelson)

A reduction in insurance coverage and an increase in prices would be noticed by U.S. businesses. You have evidence of this in the letter from the Risk and Insurance Management Society (RIMS), an association that represents insurance buyers from 81 percent of the Fortune 1000, plus about 1,000 small businesses plus local governments. Here is an excerpt from the RIMS letter:

> *"Reinsurance is an important resource used by business and insurance underwriters to control and finance risk. Many RIMS members, who represent the commercial policyholders, rely on non-US reinsurers and the robustness of this segment of the market. . . . We strongly urge you to oppose any legislation that would result in negative implications for the global reinsurance marketplace and more importantly, those US businesses who rely on this market to manage their risk exposure. . . . We would argue that targeting the non-US reinsurance market for an increase in their taxes would reduce competition and drive up prices for policyholders."*
>
> Michael Liebowitz, RIMS President
> Risk and Insurance Management Society (RIMS) represents risk managers for 81 percent of the Fortune 500, plus 1,000 small businesses, local governments and public utilities. (8/6/07 letter to Sen. Max Baucus)

Protectionist measures targeting tax increases at non-U.S. insurers will have counterproductive effects in the U.S. economy – they will make insurance more expensive and harder to buy. The additional tax costs will not ultimately fall on the non-U.S. insurers themselves, but rather on U.S. citizens -- businesses and consumers in your states.

Thank you for the opportunity to present these remarks. I would be happy to answer any question if time permits.

Attachments:

RIMS Letter
FCAN Letter

For more information contact Brad Kading, Association of Bermuda Insurers and Reinsurers (ABIR) 202-783-2434; Bradley.Kading@ABIR.bm

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[i] Reinsurance Association of America, Offshore Reinsurance in the U.S. Market, 2006 data
[ii] Dowling and Partners, IBNR, various reports 2003-2005
[iii] ABIR membership survey, 2007
[iv] Deloitte Bermuda market survey, 2007
[v] Europe's largest reinsurer is five times as large as Bermuda's largest reinsurer; the largest U.S. reinsurer is two times as large as Bermuda's largest reinsurer, Standard and Poor's, Global Reinsurance Highlights, 2006
[vi] A captive insurer is an insurer largely owned by a single business enterprise to help manage its insurance risk; business and local government associations also create captives for their member companies
[vii] Hurricane Iniki also struck Hawaii in 1992 and the Northridge Earthquake struck in California in 1994
[viii] Florida's quarter of hurricanes in 2004, Ivan, Jeanne, Francis and Charley set the stage for market problems that exploded following the 2005 hurricanes
[ix] Dowling and Partners, Insurance Information Institute
[x] GSP Consulting Corporation, Pittsburgh, PA, Analysis of the Economic Impact that Bermuda Based Insurers and Reinsurers have on the United States
[xi] In addition, 14 of our members have created European business subsidiaries.
[xii] ABIR membership survey
[xiii] Bermuda's partnership with the United States goes back centuries. Bermuda is the United Kingdom's oldest colony. Bermuda today is a self-governing, overseas territory of the U.K. It is an English speaking jurisdiction with a U.S. dollar economy. The ultimate judicial appellate court is the U.K.'s Privy Council. Bermuda used to supply the U.S. with flowers, fruits and vegetables. Bermuda has played a strategic role in the U.S. revolutionary war, the U.S. Civil War and in the North Atlantic defense in two World Wars as cited both by Winston Churchill and Franklin Roosevelt.

August 6, 2007

The Honorable Max Baucus
United States Senate
Washington, D.C. 20510

Dear Chairman Baucus:

In 2001, in response to the introduction of H.R. 1755, the "Proposed Reinsurance Tax Equity Act of 2001", the Risk and Insurance Management Society (RIMS) issued a policy statement to outline some of our concerns with this legislation. Once again, RIMS respectfully offers our views on a recently re-circulated proposal to increase the tax for non-US reinsurers.

RIMS individual members are the buyers of commercial insurance and represent a wide variety of companies - 81% of the Fortune 500 companies, as well as approximately 1,000 "small businesses" or those companies with less than 500 employees. RIMS members represent not only some of the most prestigious companies and organizations in the United States, but also state and local municipalities, school systems, and public utilities.

Actions Limiting Access to Reinsurance Capacity Should be Avoided

Reinsurance is an important resource used by business and insurance underwriters to control and finance risk. Many RIMS members, who represent the commercial policyholders, rely on non-U.S reinsurers and the robustness of this segment of the market. Maintaining a strong reinsurance market is essential in order to protect capacity and efficiency. RIMS has long fought any measures that would result in reduced capacity or competitiveness. And so, once again, we would argue that targeting the non-U.S. reinsurance market for an increase in their taxes would reduce competition and drive up prices for policyholders.

Protectionist Measures Should be Discouraged

For RIMS members, it is absolutely essential that there be a competitive and innovative global insurance and reinsurance marketplace. RIMS has a history of opposing any legislation that encumbers free market movement and the transfer of risk that is vital to a sound global insurance and reinsurance community. It is our belief that a free and fair marketplace enables both the insured and the insurers to seek innovative and affordable alternatives to manage risk. We strongly urge you to oppose any legislation that would result in negative implications for the global reinsurance marketplace and more importantly, those U.S. businesses who rely on this market to manage their risk exposure.

RIMS appreciates the opportunity to provide our comments on the issue of proposed tax increases for non-U.S. reinsurers and would be happy to discuss this issue in more detail.

Sincerely,

Michael Liebowitz

Michael Liebowitz
RIMS President

FLORIDA
Consumer Action
NETWORK

July 6, 2007

The Honorable Bill Nelson
US Senate
Washington, DC

Via Facsimile: 202-228-2183

Subject: Protectionist US Tax Proposals Will Hurt Florida Citizens

Dear Senator Nelson:

Florida's consumers are battling high insurance costs and we need your help. Consumers now understand that our insurance prices are related to reinsurance costs. Even Citizens Property Insurance uses the reinsurance markets. For that reason, I am writing you on behalf of FCAN's 30,000 members and other Floridians who share our views. Florida Consumer Action Network (FCAN) is our state's largest consumer group and is affiliated with Consumer Federation of America and USAction.

We are concerned that government policy that discourages reinsurance companies from assuming our hurricane risk will end up costing consumers. We urge you to be wary about proposed revenue raising amendments that promise the US government more tax revenue at the expense of non- US reinsurers. We believe that this action will increase reinsurance costs for Florida consumers and reduce the capacity from non US reinsurers – thus increasing insurance costs for Floridians.

In the past decade, most recently in 2000-2001, legislation (HR 1755) was proposed by domestic insurers that would increase the taxes paid by non-US reinsurers by taking punitive action against their US subsidiaries. In the early 1990's, US reinsurers had also tried to increase the excise tax on transactions with non-US reinsurers. These protectionist measures were defeated in Congress because consumers, business owners and individuals, explained that the net effect of this legislation would be to increase reinsurance costs and thus increase costs to US policyholders and businesses. Now in 2007, the same insurers are back again discussing protectionist measures that target non-US insurers but would have the effect of increasing insurance costs for US policyholders. Don't fall for this legislation. It's a protectionist trap that will especially harm Florida policyholders since they are dependent on non-US reinsurance. About 50% of Florida's reinsurance is purchased from Bermuda based reinsurance companies and any effort to increase the taxes on these carriers or their European peers will be counterproductive.

I'd like to point out that reinsurance is a healthy, competitive international market – something US policies generally advocate. We believe a robust reinsurance market, open to as many competitors as possible, is necessary to further our efforts to reduce the prices Floridians pay for insurance.. While reinsurance prices are high right now, market forces will drive them lower and Floridians will benefit.

We urge you to be on the look out for amendments proposed this summer and fall that offer hundreds of millions in additional revenue that in the end will be paid for by Florida consumers! It's not a good deal and these amendments should be exposed as protectionist measures by US insurers seeking to grab more business for themselves by increasing the taxes on their non-US competitors – taxes ultimately paid by Florida consumers.

Sincerely,

Bill Newton
Executive Director
Florida Consumer Action Network
3018 W Kennedy Blvd Ste B
Tampa, FL 33609
813-877-6712

Answers to Questions for the Record From Donald Kramer
Offshore Tax Issues
Senate Committee on Finance
September 26, 2007

Questions from Chairman Baucus

1. On an increasing basis, U.S. companies with foreign parents are competing for the same domestic business as U.S. companies with domestic parents. Some argue that the U.S. tax system should not give foreign companies a competitive advantage in insuring U.S. risks over U.S.-based companies. How do you respond to that statement?

The U.S. tax system does not give foreign companies a competitive advantage. The U.S. subsidiaries of foreign companies are subject to the same income tax laws as their U.S.-based competitors. U.S. insurers who assert otherwise focus only on whether a U.S. tax would have been imposed on investment income associated with risks ceded in affiliate reinsurance transactions, without looking at the entire tax picture. When a U.S. subsidiary cedes premium and risk to its non U.S. affiliate, it receives a ceding commission to compensate for business acquisition costs and the loss of potential income, and that ceding commission is subject to U.S. tax. Moreover, the value of the "arm's length" ceding commission required according to U.S. transfer pricing rules reflects compensation for all components of income from the ceded insurance, including investment income. Significantly, there is one aspect of U.S. law that is inapplicable to U.S. insurers and so could be viewed as having an anticompetitive effect on US subsidiaries—*viz.*, the one percent excise tax that a U.S. subsidiary is required to pay on reinsurance transactions, without regard to whether the transactions result in a profit or a loss.

2. Congress recently shut down inversion transactions because they were viewed as abusive. Aren't some of the Bermuda companies either the result of an inversion or structured to achieve similar results to that of an inversion?

The insurance and reinsurance business is global. Nearly all the companies formed in Bermuda do business on a worldwide basis, and, as noted in the ABIR testimony, they were formed at different times in response to capacity crises that arose in the United States and elsewhere. For the most part, these companies were formed in Bermuda, where personnel with key insurance and reinsurance expertise are located. More than half of ABIR members conduct business in the United States through U.S. subsidiary corporations. These companies have nearly 10,000 employees in the United States. Our members are net job creators in the United States. An economic consultant reports that these 10,000 employees in turn generate nearly 100,000 U.S. jobs from various service providers. There are a few Bermuda companies that formerly were U.S. companies. However, inversion transactions were not common in the property and casualty industry even prior to enactment of the tax disincentives applicable to corporate inversion transactions as part of the 2004 American Jobs Creation Act.

3. In your testimony you suggested that the 1-percent excise tax was sufficient to mitigate the tax competitive advantage for foreign-controlled insurance groups over domestic insurers. Can you explain with real-life examples why you believe this is true for the overall industry?

The excise tax of one percent is imposed on gross premium, whereas the 35 percent U.S. income tax is levied on net income, so the comparison is not a simple one to make. In addition, a U.S. company that cedes reinsurance generally receives a ceding commission from the reinsurer, and that ceding commission is income that is subject to the 35 percent U.S. income tax rate. Under arm's length transfer pricing principles, the ceding commission paid to a related reinsurer must compensate the ceding insurance company for the expected profitability (before losses are known) of the business ceded. The comparison is further complicated because income in the property and casualty insurance industry is highly volatile, fluctuating between gains and losses. At times those losses are substantial. In loss years the U.S. insurance industry generates tax losses that can be used to offset tax on income in profitable years. Gross premiums, on the other hand, are relatively stable and tend to grow over time. Consequently, the one percent excise tax on ceded premium, and the 35 percent tax on ceding commissions, produces a positive tax in all years. Given the volatility of income in this industry, any comparison of tax under the two alternatives has to be based on sufficient historical evidence.

Publicly available data demonstrate that over time the combination of the excise tax paid by U.S. subsidiaries plus the U.S. income tax these subsidiaries pay on the ceding commissions they receive will generate substantial tax relative to the income tax paid on business retained by U.S. companies. The attached Table 1 presents data on the losses ceded to reinsurers (related and unrelated) by the U.S. property and casualty insurance subsidiaries of 11 ABIR member companies. The data are drawn from the statutory financial statements that these U.S. companies must file with state insurance regulators. For each year from 1999 to 2006, Table 1 presents for each company the ratio of the losses ceded to reinsurers to the premiums received from reinsurers. For example, if this loss ratio has a value of 100 percent, that means that for each dollar of reinsurance premium received by the reinsurer, the reinsurer is estimated to have assumed from the ceding insurer one dollar of liability for loss payments. Table 1 shows that in many cases the loss ratio has far exceeded 100 percent, meaning that in that year the losses the U.S. subsidiary transferred to its reinsurers far exceeded the premium the U.S. subsidiary paid to the reinsurers. Moreover, these loss ratios are calculated without taking into account any ceding commissions the U.S. subsidiaries received from their reinsurers. Consequently, in many cases reinsurance caused a U.S. subsidiary's U.S. tax liability to be higher than it would have been in the absence of the reinsurance, even before taking into account federal excise tax on the ceded premium.

4. Ariel Holdings recently completed the acquisition of U.S. based Valiant Insurance Co. Your press release states that "this company will serve as the operating platform for a new specialty property and casualty insurance initiative." Do you intend to reinsure some of the U.S. business written by Valiant with an affiliate in Bermuda? If so, will the same management team play dual roles, as they do in other similar foreign groups, by working in the U.S. for Valiant and working outside the U.S. for the Bermuda affiliate? Also, often a service company is established in the U.S. to do the back office work on behalf of the Bermuda company. Do you contemplate a similar structure?

Ariel Holdings' recent acquisition, Valiant Insurance, is in the process of staffing up in the United States. Ariel purchased a "shell" corporation which did not have any employees. Ariel will be adding employees in the United States via its Valiant acquisition. U.S. personnel will be different from Bermuda personnel. In addition, Valiant will add capacity to the U.S. market in lines of business that are not written in Bermuda. Valiant will be contributing to a more competitive market in the United States, which will benefit U.S. consumers. In its formative years, Valiant will be required to cede 70 percent of its business to its parent company in order to receive the A- financial rating of its parent. For U.S. tax purposes, the start-up losses Valiant will incur will be reduced from what they otherwise would have been if all the insurance written were retained.

5. In your testimony you talk about farmers in Iowa having trouble obtaining crop insurance. To what extent is this crop insurance written by domestic affiliates ceded to related-parties located in Bermuda?

Bermuda-based companies write U.S. crop insurance on a direct basis via U.S. subsidiaries. They also assume reinsurance from both related and unrelated parties in the United States. In 2006, Bermuda-based insurers wrote 27 percent of the direct crop insurance in the United States. In total, Bermuda-based insurers and reinsurers accounted for 57 percent of the gross U.S. insurance premiums ceded by U.S. crop insurers in that year. One quarter of the companies designated by the U.S. Department of Agriculture to provide multiple peril crop insurance coverage for 2008 are Bermuda-based companies.

6. In your testimony you detailed the amounts of losses paid by ABIR members as a result of recent catastrophes and questioned where the US economy would be today without the significant contribution of the Bermuda reinsurers. How much of those catastrophe losses were paid as a result of policies written by US insurers that were ceded to affiliates?

The catastrophe losses absorbed by ABIR members are reported on a group basis. The loss numbers we cited in our testimony include both affiliate and non-affiliate insurance and reinsurance. We do not have public data for our membership which further splits out or allocates losses. The Underwriting Report for CY 2005 (the year of Katrina, Rita and Wilma) issued by the Reinsurance Association of America shows that six of the eight reporting U.S. subsidiaries of Bermuda parents reported losses in their U.S. business operations in 2005. This suggests these subsidiaries were writing and retaining property insurance exposed to hurricane losses. It is important to keep in mind that to the degree U.S. subsidiaries of ABIR members ceded the risk through reinsurance with their Bermuda parents, they also ceded the ability to utilize the associated catastrophe losses for U.S. income tax purposes.

7. In your testimony you pointed out that centers of expertise were developed in Bermuda in response to several insurance crises. What insurance crisis is being responded to today? Can you explain where the center of expertise lies for primary business being written in the US and ceded to Bermuda affiliates?

Many in the industry would agree that problems with the availability and affordability of coastal property insurance in the United States have approached crisis levels in certain states in recent years. This is the outgrowth of the hurricane experience in the United States in 2004 and 2005, which has led insurance underwriters, rating agencies and catastrophe modelers to rethink the future insurance risk stemming from hurricanes. The Bermuda insurance industry is known for its expertise in underwriting property catastrophe reinsurance. An estimated 40 percent of the U.S. property catastrophe reinsurance market is supplied by Bermuda-based carriers. Some additional catastrophe reinsurance and property insurance is written in U.S. subsidiaries of Bermuda companies. The expertise for primary business written in the United States—including marketing, underwriting, actuarial pricing and claims adjusting--can be found within these U.S. business operations.

Capacity within the U.S. property-casualty insurance industry fell substantially early in this decade. This decline in capacity occurred partly due to the September 11th terrorist attacks, which resulted in large insured losses that had the effect of reducing the capital available in the U.S. industry. In addition, in the first years of this decade many property-casualty insurers and reinsurers found that the loss reserves they had established for policies written on U.S. risks in the 1990s were wholly inadequate. In response, they were forced to increase loss reserves substantially, which reduced the capital they had available to write new business. The attached Figure 1 shows how the level of capital available in the U.S. property-casualty industry declined at the beginning of this decade.

The decline in capacity led to a substantial increase in insurance prices and made it quite profitable to write insurance business. Affiliate reinsurance provided foreign-based insurance groups that had parent companies with healthy balance sheets a quick and efficient means to increase the capacity of their U.S. affiliates to write business in this profitable market. Start-up companies were quickly formed with private equity capital to take advantage of short-run profit opportunities caused by the reduced capacity of the industry. Bermuda provided an ideal location for the start-up companies, because companies can be set up and licensed much more quickly in the Bermuda regulatory environment than they can be in the United States. The use of affiliate reinsurance enabled capital to be deployed to back the writing of insurance and reinsurance in the U.S. market without subjecting that capital to the political risk that it would become stranded in a U.S. insurance company due to the future action (or inaction) of U.S. state regulators. Keeping a greater share of the capital outside of the U.S. regulatory net preserved the flexibility of companies to redeploy that capital to more profitable uses when pricing in the U.S. insurance market turned down again.

While there was substantial growth in cross-border reinsurance flows during the first years of this decade in response to the substantial capacity shortfalls in the U.S. industry, the most recent data indicate that there is currently no trend growth in the net reliance of the U.S. property-casualty insurance industry on cross-border reinsurance, including reinsurance from affiliates and unrelated reinsurers.

8. In your testimony, you expressed concern about the difficulty homeowners from Massachusetts to Texas are experience in buying insurance to protect against hurricanes. How much of the capacity provided to U.S. insurers by their Bermuda affiliates is for homeowners insurance?

Bermuda companies provide homeowners insurance capacity not to our U.S. affiliates but rather to our U.S. customers. Investment analysts have reported that Bermuda reinsurers supply 50 percent of the property reinsurance for the single-state writers in the Florida property insurance market. Eighteen of the top 30 reinsurers supporting Florida risk are Bermuda companies. These are the carriers that now account for more than a majority of the home insurance business that is not written through the state sponsored Citizens Property Insurance Corporation. In addition, our members provide 61 percent of the reinsurance that supports the Texas Windstorm Underwriting Association and 27 percent of the reinsurance that supports the California Earthquake Authority. As a whole, Bermuda reinsurers provide an estimated 40 percent of the U.S. property reinsurance market.

Property reinsurance is capital intensive because the loss potential is enormous. Loss statistics for the Bermuda companies in 2005, as tracked and reported by Benfield (a large reinsurance broker) bear that out. Bermuda carriers lost 24 percent of their surplus in 2005, and earned a negative six percent return on equity, and eleven of the 16 companies reported losses for the year.

Questions from Senator Grassley

1. At the hearing, you suggested that the 1 percent excise tax, because it is based on gross income, creates relative tax parity with domestic P & C insurers and reinsurers, who enjoy the benefit of tax-exempt interest income. For the years 2004, 2005, and 2006, please provide the income before tax, income tax expense (current and deferred), and effective tax rates for each member of ABIR with respect to U.S. operations, and the same figures calculated by treating the 1 percent excise tax as an income tax.

The data with respect to U.S. insurance and reinsurance operations that are prepared by ABIR members are statutory financial statements for their U.S. insurance company subsidiaries, which must be prepared for U.S. state insurance regulators and are publicly available. The attached Table 2 presents effective tax rate data derived from those financial statements for the years 2002 through 2006, for the U.S. affiliates of 11 ABIR members. The effective tax rates for individual companies can vary widely from one year to the next, due to timing differences between accrual of income or losses and tax expense. Bearing that caveat in mind, the data presented in Table 2 indicate that the U.S. subsidiaries of ABIR members generally pay substantial effective income tax rates; the average effective tax rate over the five-year period ranged from approximately 22 to 100 percent.

Note that only income taxes are included in the table. The financial statements do not report federal excise tax separately from other premium taxes. It should also be noted that these data do not cover U.S. business that is insured or reinsured by the non-U.S. companies of ABIR members. Non-U.S. companies are not required to keep separate financial statements segregating their U.S.-source business from other business.

2. Some view the affiliated offshore reinsurance issue as a transfer pricing issue, while others draw an analogy to "earnings stripping" through the us[e] of related party debt. I understand your view to be that it is a transfer pricing issue. Please explain in more detail (i) why you think this is a transfer pricing issue, (ii) why current law transfer pricing rules, and enforcement of those rules, is sufficient to police related party reinsurance transactions, and (iii) how the tax issues associated with related party reinsurance are similar to, or different from, the tax issues associated with related party debt.

For federal income tax purposes, affiliate reinsurance transactions, whether domestic or cross-border, must comply with transfer pricing rules which require the terms and conditions of a transaction to mirror the arm's length terms and conditions of reinsurance transactions between unrelated parties. The Internal Revenue Service has substantial authority under current sections 482 and 845 of the Internal Revenue Code to police these transactions and to make any necessary adjustments to prevent tax evasion and to clearly reflect income. In practice, companies prepare transfer pricing studies to document that their transactions comply with these tax law requirements. These transfer pricing studies also are subject to review by state insurance regulators, since affiliate reinsurance is subject to regulatory approval as well.

The current law rules relating to "earnings stripping" only apply to the issuance of debt and the payment of deductible interest to a foreign related party. By contrast, affiliate reinsurance transfers both premium and risk to a foreign related party. Most significantly, the amount of losses that ultimately may be borne by the reinsurer is not known at the time the transaction is entered into. By contrast, in the case of related-party debt, the foreign related party recipient of interest payments earns income 100 percent of the time. Imposing unfavorable U.S. tax treatment on reinsured premiums would disrupt the core business of the property and casualty insurance industry, whereas a limitation on "excess" interest merely re-characterizes the form in which a foreign group has chosen to capitalize a U.S. subsidiary.

3. At the hearing, Mr. Berkley said that related party reinsurance is merely a bookkeeping entry. What is your reaction to that? Please explain economic substance of a related party reinsurance transaction.

Both U.S. insurers and non-U.S. insurers use affiliate reinsurance for non-tax business purposes, and the extensive use of affiliate reinsurance is common. Affiliate reinsurance is an efficient tool to manage risk and capital within a group of insurance companies. Rating agencies and state insurance regulators alike recognize the economic substance and importance of affiliate reinsurance.

Affiliate reinsurance involves the real economic transfer of risk between two separately incorporated entities, pursuant to legally binding contracts. Critics argue that U.S. insurers can "cherry pick" business and use bookkeeping entries to cede offshore only business they know is profitable, while leaving unprofitable business onshore. This is absurd. The essence of reinsurance is the transfer of risk, and therefore no reinsurer knows at the time it writes business which policies or lines of business will turn out to be profitable and which will not.

Ample evidence exists that affiliate reinsurance can result in the ceding of unprofitable business to non-U.S. reinsurers. The attached Table 1 presents loss ratios for business ceded to reinsurers by U.S. subsidiaries of 11 ABIR members. While the data presented in the table cover cessions to affiliated and unaffiliated reinsurers (because the statutory financial statements from which the data were derived do not report these particular numbers separately for affiliated and unaffiliated reinsurers) for many of the subsidiaries a substantial part of their reinsurance was with affiliates. Table 1 shows that the losses ceded to reinsurers have frequently exceeded the premiums paid to the reinsurers. Moreover, the numbers in the table do not take into account the ceding commission often paid by the reinsurer to the ceding company, which can amount to 20 to 30 percent or more of the premium.

In fact, it is not only impossible for property and casualty insurers to know what their losses will be at the time policies are written. It also can be difficult for insurers to estimate accurately what incurred losses ultimately will be paid, even for some time after the events giving rise to the losses have occurred. This is because an insurance claim may not be filed, and a final settlement of that claim may not occur, until some time after the event giving rise the claim occurred. Consequently, uncertainty about the magnitude of insurance losses resolves itself only over time as claims are filed and losses are paid.

The attached Table 3 demonstrates this point. For the U.S. subsidiaries of a number of ABIR members, the table presents for several years the percent difference between the incurred losses for the year as estimated at the end of the year and the incurred losses for the same year estimated as of the end of 2006. For example, if the figure in the table for 2002 for a particular company was 30 percent, then that would mean that between the end of 2002 and 2006, the company increased its estimate of the losses it incurred during

2002 by 30 percent. One would expect the 2006 estimate to be much more accurate than the 2002 estimate because much more of the losses would have been reported or paid by 2006.

In many cases, the percent change in loss estimates shown in Table 3 is large enough to turn what might have been an anticipated profit into a large loss. Given the uncertainty about the magnitude of losses that is demonstrated by the figures in Table 3, it is not credible to suggest that insurers can use affiliate reinsurance transactions as if they were bookkeeping entries to "cherry pick" profitable business for affiliate reinsurance.

4. Please provide a more complete answer to the following question asked at the hearing: I understand reinsurance relates primarily to risk sharing. According to the Reinsurance Association of America, reinsurance with offshore affiliates is "undertaken to achieve corporate objectives that extend beyond risk sharing." What are those other objectives?

As we noted in our testimony, affiliate reinsurance is used routinely within U.S.-based insurance company groups for non-tax business reasons. Reinsurance may be used to transfer liabilities within a corporate group in order to provide an affiliate additional capacity, allow it to transfer risks that fall outside its underwriting parameters, or to protect an affiliate in the event of catastrophic loss. It also may allow certain types of risks to be pooled, thereby enabling the company to track experience on a line of business, so that it can price the coverage adequately in future years.

Global insurance groups use reinsurance for the same business reasons. In addition to risk transfer, reinsurance facilitates the management of capital within the group, and provides the flexibility necessary to respond quickly to business opportunities wherever they arise. Each separately licensed insurance entity within a group must comply with specific regulatory capital requirements that can tie down (or "trap") capital and effectively limit the amount of business that can be written from that entity. The use of reinsurance enables the group to manage this problem. Reinsurance also permits an insurance group to build up capital in a flagship enterprise. Pooling capital in a flagship company allows the insurer the maximum flexibility to support financially-affiliated parties and to enter and exit markets as business opportunities arise.

State insurance regulators scrutinize reinsurance transactions closely. The foreign-owned U.S. domestic insurer must comply with specific state regulation as to rate, form and consumer protection. Reinsurance to a non-U.S. parent expands the ability of the U.S. company to supply needed insurance capacity to the U.S. market. The corporate ratings agencies such as AM Best look to see if subsidiaries within an insurance group will use affiliate reinsurance to avoid trapping capital in entities created for specific market segments. These rating agencies tend to view the use of affiliate reinsurance transactions to pool capital and risk as strengthening the enterprise, and the better the financial rating the better the opportunity to assure those who purchase insurance that the promise to pay will be met when needed.

Questions from Senator Lott

1. In your testimony, you point out that approximately 50 percent of the insurance and reinsurance claims paid for Hurricane Katrina losses came from the non-U.S. reinsurers, and that Bermuda's carriers alone contributed 24 percent of [ ] that total. If we were to change the tax law, and adopt a proposal similar to what was discussed at the Hearing -- deferral of the loss reserve deduction for related party offshore reinsurance until the claim is paid -- what impact would it have on the availability of non-U.S. reinsurance?

The proposal as described would impose a prohibitively high tax cost on the affiliate reinsurance transactions of non-U.S. insurance groups. As we have explained in our responses to other questions, affiliate reinsurance provides an efficient and flexible way for insurance company groups, both U.S. and non-U.S., to manage risk and capital within the group. Subjecting the non-U.S. carriers to punitive taxation of reinsurance transactions with their U.S. affiliates would therefore increase their costs and inhibit their ability to serve the U.S. market. The direct consequence would be a reduction in the supply of insurance and reinsurance capacity in the U.S. market, and a decline in competition in the U.S. market between U.S. and non-U.S. carriers. This would invariably lead to increased insurance prices and greater difficulty in obtaining some kinds of insurance coverage.

2. If the proposal mentioned in the previous question were to be adopted, do you think other firms would step in to these markets to provide the reinsurance necessary to sustain coverage at or near current rates? If you do not, please explain your analysis. Do you think firms would simply abandon markets?

If reinsurance capacity were disrupted by new punitive U.S. tax measures, prices for coverage would increase, certainly in the short run, due to capacity shortfalls. Some types of insurance coverage could become difficult to obtain. Rising prices eventually would attract new capital into U.S. companies to meet the coverage gap, but this adjustment would take time. Furthermore, forcing the new capital into U.S. companies would mean that it would be subject to the cumbersome U.S. insurance regulatory regime. Regulatory action, or inaction, can inhibit the ability of an insurance group to redeploy capital among the U.S. and foreign companies within the group in response to changes in the market. Therefore, forcing the new capital into U.S. companies would likely permanently raise costs of providing U.S. coverage, which of course would mean permanently higher prices for this coverage.

Punitive tax treatment of affiliate reinsurance by non-U.S. insurance carriers would likely also lead to greater price volatility in the U.S. market, with more severe price spikes in response to future supply shocks such as those caused by major catastrophes. Non-U.S. carriers have provided an important shock absorber for the U.S. market, dampening the impact of these supply shocks by quickly adding new capacity to the U.S. market in response to rising prices. For the U.S. affiliates of foreign insurance groups, reinsurance from a foreign parent with a strong balance sheet can provide a quick and efficient way to increase the capacity to write new U.S. business and take advantage of short-term profit opportunities provided by a supply shock. In addition, affiliate reinsurance allows for more flexibility and efficiency in how the group's capital can be employed. Moving more capital into a U.S. affiliate subjects that capital to the U.S. insurance regulatory regime, and to the possibility that future regulatory action may strand that capital in the United States, when it could be more profitably deployed elsewhere in the world.

Similarly, foreign-based start-up companies have added new capacity to the U.S. market in response to supply shocks. The flexible and responsive regulatory regime in Bermuda has made it an attractive location to base these start-up companies. The private equity investors that generally fund these start-ups seek to take advantage of the short-term profit opportunities in the U.S. insurance market caused by supply shocks, and they are not necessarily seeking to commit their capital for the long term. Therefore, a structure in which a significant part of the start-up company's capital can remain outside the U.S. regulatory regime is attractive.

When insurance prices rise due to supply shocks, the ability of a company to get capital deployed quickly to support new insurance business benefits the company, which is able to take advantage of high prices, but consumers also benefit. Rapid entry of new capacity into the market reduces the duration and severity of the insurance price spikes that occur after supply shocks. Penalizing affiliate reinsurance by foreign-based insurance carriers would restrict their ability to add capacity to the U.S. market rapidly, flexibly, and efficiently. The detrimental consequences for U.S. consumers are obvious.

3. Do you believe that related party reinsurance spreads insurance risk in the same was as unrelated company's use of reinsurance?

As noted above in our responses to questions from Senator Grassley, affiliate reinsurance transactions, whether domestic or cross-border, must comply with an arm's length standard under transfer pricing rules, which means these transactions are conducted in the same manner as reinsurance transactions between unrelated parties. Both affiliate and non-affiliate reinsurance transactions transfer risk to the reinsurer, pursuant to legally binding contracts. And ceding companies in both instances are subject to scrutiny from state insurance regulators.

Table 1
U.S. Subsidiaries of ABIR Members
Loss Ratio of Business Ceded to Reinsurers
Statutory Data
1999 - 2006

Line	Company	1999	2000	2001	2002	2003	2004	2005	2006
1	Ace Ltd	103.5%	112.7%	119.3%	76.5%	54.8%	67.3%	73.9%	63.1%
2	Allied World Assur Holding Grp	N/A	N/A	64.1%	45.1%	59.6%	99.6%	103.0%	70.7%
3	Arch Capital Group	N/A	N/A	153.2%	81.6%	58.0%	62.9%	81.1%	60.6%
4	Argonaut Grp	135.5%	137.0%	73.9%	47.8%	42.9%	51.6%	84.7%	58.6%
5	Aspen Specialty Ins Co	97.3%	5.6%	140.9%	66.7%	57.2%	44.4%	271.1%	37.3%
6	Axis Capital Grp	N/A	N/A	N/A	87.9%	51.3%	97.1%	111.8%	59.6%
7	Endurance Group	N/A	N/A	N/A	N/A	45.2%	64.2%	90.1%	46.3%
8	PartnerRe Grp	147.3%	808.7%	923.5%	6.5%	1.9%	66.0%	85.0%	61.8%
9	Platinum Underwriters Reins Co.	N/A	N/A	N/A	N/A	55.9%	112.7%	134.1%	67.7%
10	Renaissance Re Grp	96.1%	85.0%	83.6%	45.2%	30.5%	64.4%	63.2%	61.1%
11	X L America	125.1%	111.6%	154.8%	72.1%	61.6%	60.7%	93.0%	57.6%

Note: N/A values used for years in which data were unavailable or no premiums were ceded to reinsurers

Table 2
Effective Tax Rates
U.S. Subsidiaries of ABIR Members
Statutory Data
2002-2006

$ figures in 000s

	US Groups / Companies	2002	2003	2004	2005	2006	2002-2006
	Pretax Income						
1	Ace Ltd	$22,619	$535,200	$62,860	$667,942	$1,174,695	$2,463,316
2	Allied World Assur Holding Grp	$11,384	$20,075	($10,942)	$3,487	$7,932	$31,936
3	Arch Capital Group	$9,139	$78,163	$89,730	$84,518	$81,025	$342,575
4	Argonaut Grp	$2,618	$104,285	$76,511	$43,831	$186,219	$413,464
5	Aspen Specialty Ins Co	$2,212	($2,434)	($12,045)	($1,042)	($16,419)	($29,728)
6	Axis Capital Grp	$52,121	($13,294)	$13,537	($15,973)	$94,246	$130,637
7	Endurance Grp	N/A	($82,906)	($41,069)	($82,960)	$72,986	($133,949)
8	PartnerRe Grp	$12,841	($8,098)	$36,200	$6,083	$88,193	$135,219
9	Platinum Underwriters Reins Co.	($32,698)	$109,119	$50,536	($23,248)	$156,399	$260,108
10	Renaissance Re Grp	($4,943)	($13,327)	($11,538)	$445	$19,092	($10,271)
11	X L America	$59,688	($183,777)	$209,617	$122,578	$321,740	$529,846
	Income Taxes Incurred						
12	Ace Ltd	$111,062	$101,835	$142,274	$267,583	$470,546	$1,093,300
13	Allied World Assur Holding Grp	$4,592	$8,348	($108)	($2,604)	$5,054	$15,282
14	Arch Capital Group	$9,594	$43,626	$49,024	$30,049	$25,968	$158,261
15	Argonaut Grp	$4,257	$29,935	$27,620	$32,148	$56,316	$150,276
16	Aspen Specialty Ins Co	$866	$294	$0	$72	($907)	$325
17	Axis Capital Grp	$20,214	$10,853	$18,581	$35,938	$44,662	$130,248
18	Endurance Grp	N/A	($20)	$0	($7)	$7,202	$7,175
19	PartnerRe Grp	$6,854	$25,489	$22,224	($3,962)	$21,613	$72,218
20	Platinum Underwriters Reins Co.	$0	$58,473	$29,962	($1,363)	$38,419	$125,491
21	Renaissance Re Grp	$0	$0	$0	$107	$827	$934
22	X L America	($41,683)	$9,281	$19,370	$62,695	$67,729	$117,392
	Effective Tax Rate						
23	Ace Ltd	491.0%	19.0%	226.3%	40.1%	40.1%	44.4%
24	Allied World Assur Holding Grp	40.3%	41.6%	N/A	-74.7%	63.7%	47.9%
25	Arch Capital Group	105.0%	55.8%	54.6%	35.6%	32.0%	46.2%
26	Argonaut Grp	162.6%	28.7%	36.1%	73.3%	30.2%	36.3%
27	Aspen Specialty Ins Co	39.2%	N/A	N/A	N/A	N/A	N/A
28	Axis Capital Grp	38.8%	N/A	137.3%	N/A	47.4%	99.7%
29	Endurance Grp	N/A	N/A	N/A	N/A	9.9%	N/A
30	PartnerRe Grp	53.4%	N/A	61.4%	-65.1%	24.5%	53.4%
31	Platinum Underwriters Reins Co.	N/A	53.6%	59.3%	N/A	24.6%	48.2%
32	Renaissance Re Grp	N/A	N/A	N/A	24.0%	4.3%	N/A
33	X L America	-69.8%	N/A	9.2%	51.1%	21.1%	22.2%

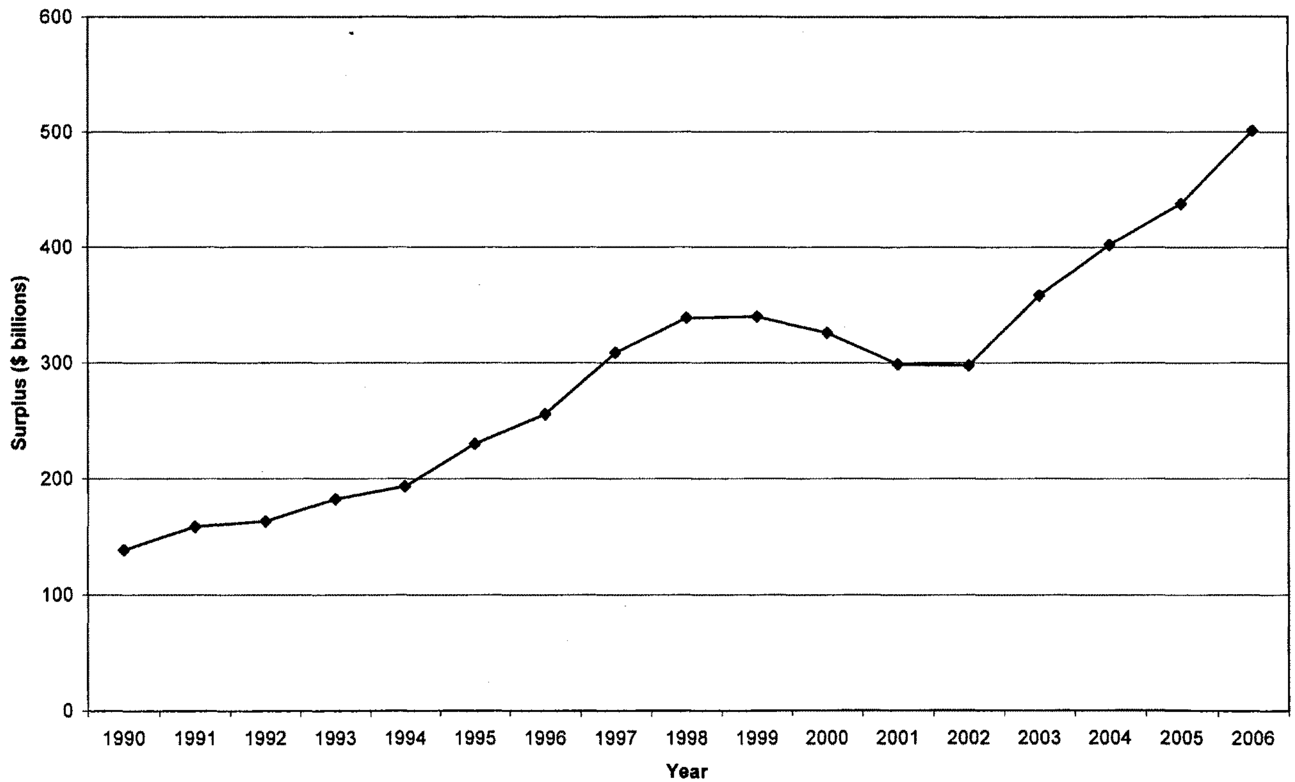
Note: "N/A" values used for years in which group/company had negative pretax income.

Table 3
U.S. Subsidiaries of ABIR Members
Percent Change in Estimated Losses Incurred from End of Year in Which Losses Incurred to End of 2006
Statutory Data

Line	Company	1999	2000	2001	2002	2003
1	Ace Ltd	20.5%	4.6%	22.4%	20.7%	-7.3%
2	Allied World Assur Holding Grp	N/A	N/A	0.0%	-42.7%	-19.5%
3	Arch Capital Group	N/A	N/A	-30.7%	29.1%	-1.5%
4	Argonaut Grp	32.3%	16.7%	-4.5%	-2.9%	-7.7%
5	Aspen Specialty Ins Co	20.0%	N/A	2478.9%	792.0%	66.5%
6	Axis Capital Grp	N/A	N/A	N/A	44.4%	-17.2%
7	Endurance Group	N/A	N/A	N/A	N/A	-25.2%
8	PartnerRe Grp	41.6%	10.0%	23.9%	14.4%	-15.2%
9	Platinum Underwriters Reins Co.	N/A	N/A	N/A	-38.6%	-3.8%
10	Renaissance Re Grp	17.7%	112.7%	73.6%	49.3%	296.7%
11	X L America	128.4%	54.7%	54.4%	35.1%	-2.4%

Note: N/A values used for years in which data were unavailable or initial loss estimate was equal to zero.

Figure 1: U.S. P&C Industry Surplus (Capital)



SENATOR TRENT LOTT STATEMENT
September 26, 2007

Thank you, Mr. Chairman.

I want to thank the witnesses for being here today and want to focus my attention on Mr. Berkley and Mr. Kramer.

Since Hurricane Katrina, I have taken a keen interest in the Property and Casualty industry, so issues affecting them are of great interest to me.

The issue as I see it is quite clear—the domestic industry is at a competitive disadvantage relative to foreign based reinsurers based almost exclusively on the current tax code.

Now I realize that much of this can be attributed to lower corporate rates abroad, and I think we all agree that lower corporate tax rates are needed to ensure the U.S. remains a globally competitive place to do business. Tax competitiveness is critically important in the global economy. We need to remain competitive to keep creating jobs and a growing economy.

But, it is unrealistic for us to believe that we can compete against a zero tax jurisdiction like Bermuda with little to no corporate tax burden. Certainly it is something to aspire to, but in practical terms, aren't we left in a quandary?

On one hand, some will argue that by limiting the ability of certain firms to reinsure with related parties offshore, we will reduce capacity to write primary insurance domestically and that there will be a negative affect on pricing (i.e., premiums will increase).

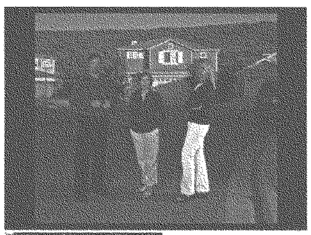
Well, Mr. Kramer, that is already a HUGE problem in my state. Trying to find a solution to this problem has been vexing me. P&C firms won't write coverage on the coast, but will go several miles inland and write all sorts of policies. In Mississippi, just like other states, businesses, homeowners, and others need property and casualty insurance to protect themselves against the substantial risks they face.

If we take certain measures to protect the domestic P&C folks as has been argued this morning, will it really affect pricing and dry up the market because less reinsurance will be available? I realize that a jurisdiction like Bermuda may have a more favorable regulatory structure for your business, but if we address an unfair tax advantage, I question the line of thought that firms will simply abandon our domestic markets.

Bloomberg.com

Home Insurers' Secret Tactics Cheat Fire Victims, Hike Profits

By David Dietz and Darrell Preston



Aug. 3 (Bloomberg) -- Julie Tunnell remembers standing in her debris-strewn driveway when the tall man in blue jeans approached. Her northern San Diego tudor-style home had been incinerated a week earlier in the largest wildfire in California history. The blaze in October and November 2003 swept across an area 19 times the size of Manhattan, destroying 2,232 homes and killing 15 people.

Now came another blow. A representative of State Farm Mutual Automobile Insurance Co., the largest home insurer in the U.S., came to the charred remnants of Tunnell's home to tell her the company would pay just $220,000 of the estimated $306,000 cost of rebuilding the house.

``It was devastating; I stood there and cried,'' says Tunnell, 42, who teaches accounting at San Diego City College. ``I felt absolutely abandoned.''

Tunnell joined thousands of people in the U.S. who already knew a secret about the insurance industry: When there's a disaster, the companies homeowners count on to protect them from financial ruin routinely pay less than what policies promise.

Insurers often pay 30-60 percent of the cost of rebuilding a damaged home -- even when carriers assure homeowners they're fully covered, thousands of complaints with state insurance departments and civil court cases show.

Paying out less to victims of catastrophes has helped produce record profits. In the past 12 years, insurance company net income has soared -- even in the wake of Hurricane Katrina, the worst natural disaster in U.S. history.

Highest-Ever Profits

Property-casualty insurers, which cover damage to homes and cars, reported their highest-ever profit of $73 billion last year, up 49 percent from $49 billion in 2005, according to Highline Data LLC, a Cambridge, Massachusetts-based firm that compiles insurance industry data.

The 60 million U.S. homeowners who pay more than $50 billion a year in insurance premiums are often disappointed when they discover insurers won't pay the full cost of rebuilding their damaged or destroyed homes.

Property insurers systematically deny and reduce their policyholders' claims, according to court records in California, Florida, Illinois, Mississippi, New Hampshire and Tennessee.

The insurance companies routinely refuse to pay market prices for homes and replacement contents, they use computer programs to cut payouts, they change policy coverage with no clear explanation, they ignore or alter engineering reports, and they sometimes ask their adjusters to lie to customers, court records and interviews with former employees and state regulators show.

`It's Despicable'

As Mississippi Republican U.S. Senator Trent Lott and thousands of other homeowners have found, insurers make low offers -- or refuse to pay at all -- and then dare people to fight back.

``It's despicable not to make good-faith offers to everybody,'' says Robert Hunter, who was Texas insurance commissioner from 1993 to 1995 and is now insurance director at the Washington-based Consumer Federation of America.

``Money managers have taken over this whole industry,'' Hunter says. ``Their eyes are not on people who are hurt but on the bottom line for the next quarter.''

The industry's drive for profit has overwhelmed its obligation to policyholders, says California Lieutenant Governor John Garamendi, a Democrat. As California's insurance commissioner from 2002 to 2006, Garamendi imposed $18.4 million in fines against carriers for mistreating customers.

``There's a fundamental economic conflict between the customer and the company,'' he says. ``That is, the company doesn't want to pay. The first commandment of insurance is, `Thou shalt pay as little and as late as possible.'''

Allstate Hires Consultant

Although the tension between insurers and their customers has long existed, it was in the 1990s that the industry began systematically looking for ways to increase profits by streamlining claims handling.

Hurricane Hugo was a major catalyst. The 1989 storm, which battered North and South Carolina, left the industry reeling from $4.2 billion in claims.

In September 1992, Allstate Corp., the second-largest U.S. home insurer, sought advice on improved efficiency from McKinsey & Co., a New York-based consulting firm that has advised many of the world's biggest corporations, according to records in at least six civil court cases.

State Farm, based in Bloomington, Illinois, and Los Angeles-based Farmers Group Inc., the third-largest home insurer in the U.S., also hired McKinsey as a consultant, court records show.

`Boxing Gloves'

McKinsey produced about 13,000 pages of documents, including PowerPoint slides, in the 1990s, for Northbrook, Illinois-based Allstate. The consulting firm developed methods for the company to become more profitable by paying out less in claims, according to videotaped evidence presented in Fayette Circuit Court in Lexington, Kentucky, in a civil case involving a 1997 car accident.

One slide McKinsey prepared for Allstate was entitled ``Good Hands or Boxing Gloves,'' the tape of the Kentucky court hearing shows. For 57 years, Allstate has advertised its employees as the ``Good Hands People,'' telling customers they will be well cared for in times of need.

The McKinsey slides had a new twist on that slogan.

When a policyholder files a claim, first make a low offer, McKinsey advised Allstate. If a client accepts the low amount, Allstate should treat the person with good hands, McKinsey said. If the customer protests or hires a lawyer, Allstate should fight back.

``If you don't take the pittance they offer, they're going to put on the boxing gloves and they're going to batter injured victims,'' plaintiffs attorney J. Dale Golden told Judge Thomas Clark at the May 12, 2005, hearing in which the lawyer introduced the McKinsey slides.

The Alligator

One McKinsey slide displayed at the Kentucky hearing featured an alligator with the caption ``Sit and Wait.'' The slide says Allstate can discourage claimants by delaying settlements and stalling court proceedings.

By postponing payments, insurance companies can hold money longer and make more on their investments -- and often wear down clients to the point of dropping a challenge. ``An alligator sits and waits,'' Golden told the judge, as they looked at the slide describing a reptile.

McKinsey's advice helped spark a turnaround in Allstate's finances. The company's profit rose 140 percent to $4.99 billion in 2006, up from $2.08 billion in 1996. Allstate lifted its income partly by paying less to its policyholders.

`Stars in Alignment'

Allstate spent 58 percent of its premium income in 2006 for claim payouts and the costs of the process compared with 79 percent in 1996, according to filings with the U.S. Securities and Exchange Commission.

The payout expense, called a loss ratio, changes each year based on events such as natural disasters; overall, it's been decreasing since Allstate hired McKinsey.

Investors have noticed. Allstate's stock price jumped fourfold to $60.95 on July 11 from its closing price on June 3, 1993, the day of its initial public offering. During the same period, the Standard & Poor's 500 Index rose threefold.

State Farm's profits have doubled since 1996 to $4.8 billion in 2006. Because State Farm is a mutual company, meaning it's owned by its policyholders, it doesn't have shares that trade publicly.

``This is about as good a stretch as I've seen,'' says Michael Chren, who manages $1.5 billion at Allegiant Asset Management Co. in Palm Beach Gardens, Florida, and has followed the property-casualty industry for 20 years.

The industry's performance during the past five years has been superb, even with payouts for Katrina, he says. ``All the stars have been in alignment,'' he says. ``There has been decent pricing of products and an extremely attractive and very low loss ratio.''

`More Audacious'

Reducing payouts is just one way the industry has improved profits.

Carriers have also raised premiums and withdrawn from storm-plagued areas such as the Gulf Coast of the U.S. and parts of Long Island, New York -- to lower costs and increase income, says Amy Bach, executive director of United Policyholders, a San Francisco-based group that advises consumers on insurance claims.

``What this says is that the industry has been raking in spectacular profits while they're getting more and more audacious in their tactics,'' she says.

Allstate spokesman Michael Siemienas says the company won't comment on what role McKinsey played in lowering the insurer's loss ratio and boosting its profits. Allstate did change the way it handles homeowners' insurance claims, he says.

`Absolutely Sound'

``In the early 1990s, Allstate redesigned its claims practices to more efficiently and effectively handle claims and better serve our customers,'' he says.

``Allstate's goal remains the same: to investigate, evaluate and promptly resolve each claim based on its merits,'' Siemienas says. ``Allstate believes its claim processes support this goal and are absolutely sound.''

McKinsey doesn't discuss any of its work for clients, spokesman Mark Garrett says.

Jerry Choate, Allstate's chief executive officer from 1995 to 1998, said at a news conference in New York in 1997 that the company's new claims-handling process had reduced payments and increased profit, according to a report in a March 1997 edition of National Underwriter magazine.

Insurers can't make significantly more money just from cutting sales costs, he told reporters. ``The leverage is really on the claims side," Choate said. ``If you don't win there, I don't care what you do on the front end. You're not going to win."

The more cash insurers can keep from premiums, the more they can invest. This pool of assets -- most of which the companies invest in government and corporate bonds -- is known as float.

`Better Than Free'

``Simply put, float is money we hold that is not ours but which we get to invest," billionaire Warren Buffett, CEO of Berkshire Hathaway Inc., wrote in his annual letter to shareholders this year. ``When an insurer earns an underwriting profit, float is better than free," he wrote in 2006.

Omaha, Nebraska-based Berkshire Hathaway generated 51 percent of its $11 billion profit in 2006 from insurance.

Claims payouts for the entire property-casualty industry have decreased in the past decade. In 2006, carriers paid out 55 percent of the $435.8 billion in premiums collected, according to the Insurance Information Institute, a trade group in New York.

That compares with a 64 percent payout ratio on $267.6 billion in premium revenue in 1996. As companies pay less to policyholders, their investment gains are growing, according to the trade group and research firm A.M. Best Co. in Oldwick, New Jersey.

`Purpose Evaporating'

The industry has increased profits by an annual average of 46 percent since 1994, Institute data show. In 2006, carriers invested $1.2 trillion and recorded a net gain of $52.3 billion, up from $713.5 billion invested for a gain of $39.1 billion in 1994.

Insurance companies are no longer following their mandate to take care of policyholders' money and then pay it out when needed, says Douglas Heller, executive director of the nonprofit Foundation for Taxpayer and Consumer Rights in Santa Monica, California.

``The whole purpose of insurance is evaporating before our eyes as we continue to send checks to the companies," Heller says. ``Insurers are looking to shed their purpose as a risk bearer and become financial institutions."

That kind of criticism is unwarranted, says Robert Hartwig, chief economist at the Insurance Information Institute. He says about 1 percent of policyholders contest what they're offered.

`Justifiably Proud'

``The insurance industry can be justifiably proud of its performance," Hartwig says. ``It's in the insurance industry's best interests to settle claims as fairly and as rapidly as possible."

Companies have sharpened the use of technology in the past 20 years to help tighten claims payouts.

Insurers following McKinsey's advice on claims processing have adopted computer programs with names such as Colossus and Xactimate.

Colossus, made by El Segundo, California-based Computer Sciences Corp., calculates the cost of treating people injured in auto accidents, including the degree of pain and suffering they'll endure and any permanent impairment they may have, according to Computer Sciences' Web site.

Xactimate, made by Xactware Solutions Inc. of Orem, Utah, is a program that estimates the cost of rebuilding a home.

`Designed to Underpay'

Insurers sometimes manipulate these programs to pay out as little as possible, lawsuits have asserted. ``Programs like Colossus are designed to systematically underpay policyholders without adequately examining the validity of each individual claim," former Texas insurance commissioner Hunter told the U.S. Senate Committee on Commerce, Science and Transportation on April 11.

He also criticized Xactimate. ``If you don't accept their offer, which is a low ball, you end up in court,'' Hunter said. ``And that was the recommendation of McKinsey.''

Computer Sciences and Xactware declined to comment.

Farmers Group, a subsidiary of Zurich Financial Services AG, agreed in 2005 to stop using Colossus to evaluate claims filed by policyholders who have accidents with uninsured or underinsured drivers.

The move was part of a $40 million settlement in a class- action lawsuit in Pottawatomie County District Court in Oklahoma in which the plaintiffs claimed the company had repeatedly and wrongly failed to pay enough for crash injuries.

`A Toothy Grin'

An internal e-mail introduced in the Farmers lawsuit shows the company had pressured its adjusters, whom it calls claims representatives, or CRs, to pay out smaller amounts -- and rewarded them when they did.

``As you know, we have been creeping up in settlements,'' David Harding, a Farmers claims manager, wrote in an e-mail to employees on Nov. 20, 2001. ``Our CRs must resist the temptation of paying more just to move this type file. Teach them to say, `Sorry, no more,' with a toothy grin and mean it.''

Harding praised a worker for making low settlements. ``It can be done as Darren consistently does,'' he wrote. ``If he keeps this up during 2002, we will pay him accordingly.''

Farmers said in court papers that it didn't seek to pay less than customers were due. ``The e-mail speaks for itself,'' Farmers wrote. ``Plaintiff's characterization of it is denied.''

`More Efficient'

Edward Rust Jr., CEO of State Farm, testified in a 2006 civil case that his company revamped its claims handling through a project called ACE, or Advanced Claims Excellence. McKinsey suggested the use of ACE, according to evidence presented in the district court of Grady County, Oklahoma.

``Technology has allowed us to really streamline our claim organization to be more efficient and responsive,'' Rust testified. He said the company wanted to cut expenses for claims.

In the Oklahoma case, Bridget and Donald Watkins, whose Grady County house was destroyed during a tornado in 1999, accused State Farm of misrepresenting the damage from the storm and won a $12.9 million judgment in May 2006. Watkins and State Farm agreed to an undisclosed settlement after the judgment.

Hunter, who also headed the federal flood insurance program under Presidents Gerald Ford and Jimmy Carter, told Congress that Allstate, with McKinsey's guidance, gave the name Claim Core Process Redesign to its strategy to change payout practices.

As pervasive as computers have become in insurance, the key actor in settling claims is still the adjuster, the person who talks to policyholders and decides how much they should be paid.

`Told To Lie'

Allstate has asked adjusters to deceive customers, says Jo Ann Katzman, who worked as a claims adjuster for Allstate in 2002 and 2003. She says managers regularly came to her office in Farmington Hills, Michigan, to give pep talks on keeping claim payments down.

They awarded prizes such as portable refrigerators to adjusters who tried to deny claims by blaming fires on arson without justification, she says. ``We were told to lie by our supervisors,'' says Katzman, 49, who quit by taking a company buyout in 2003. ``It's tough to look at people and know you're lying.''

Katzman says an adjuster at Allstate, on orders from a supervisor, told an 89-year-old Detroit fire victim that Allstate wouldn't replace cabinets in her home even though the insurance policy said they were covered.

In another case, Katzman says Allstate wouldn't replace a fire-damaged refrigerator -- an appliance she says was covered. Katzman now runs Accurate Estimating Services, an independent adjusting company in Bloomfield Hills, Michigan.

Allstate's Siemienas declined to comment on Katzman's statements.

Punitive Damages

Insurers sometimes order employees to offer replacement cost settlements that have no connection to actual prices of home contents, according to testimony in a civil trial.

A jury in November 2005 awarded Larry Stone and Linda Della Pelle $5.2 million in punitive damages and $616,000 to construct a new house after finding that Fidelity National Insurance Co. of Jacksonville, Florida, had underpaid the couple by $183,000 when it offered them $433,000 to rebuild their two-story Claremont, California, residence.

During the trial in Los Angeles Superior Court, Ricardo Echeverria, the couple's attorney, questioned Kenneth Drake, president of Canyon Country, California-based RJG Construction Inc., who had been hired by Fidelity's lawyers to evaluate damage estimates.

`Do You Think That's Fair?'

``Are you telling us that sometimes, because the insurance carriers dictate what amounts they are willing to allow for unit costs, estimators then have to comply with that?'' asked Echeverria, according to the court transcript.

``That's absolutely true,'' Drake said.

``Do you think that's fair?'' Echeverria asked.

``Fair or not, it's the name of our business,'' Drake said.

Drake declined to comment on his testimony. Fidelity is appealing the award.

A New Hampshire case involving a home destroyed in a fire exposed another insurance company tactic: changing a policy retroactively.

In April 2003, the Rockingham county attorney in Kingston, New Hampshire, found that a unit of Hartford Financial Services Group Inc. had deleted the replacement cost portion of the homeowner's policy of Terry Bennett after his five-bedroom house burned to the ground in 1993.

`Wrong End'

Bennett, a physician, sued Twin City Fire Insurance Co., claiming his home and its contents -- including antiques and fine art -- were worth $20 million, not the $1.7 million the insurer paid him. After an 11-year battle, he settled with Hartford in 2004 for an undisclosed amount.

``Fighting an insurance company is like staring down the wrong end of a cannon,'' Bennett says.

An unprecedented number of people stared down that cannon after Hurricane Katrina. The August 2005 storm killed more than 1,600 people in Louisiana and Mississippi, left 500,000 people homeless and cost insurers $41.1 billion.

More than 1,000 homeowners sued their insurers in the wake of the storm -- the largest-ever number of insurance lawsuits stemming from a U.S. natural disaster.

For insurers, the multibillion-dollar question regarding Katrina was how much of the destruction was caused by wind and how much by water. Property insurance policies don't cover damage caused by flooding; homeowners have to purchase separate insurance administered by the U.S. government.

Altering Reports

The wind/water issue has spurred allegations that insurers manipulated the findings of adjusters and engineers.

Ken Overstreet, an engineer based in Diamondhead, Mississippi, who examined destroyed Gulf Coast residences, says someone altered his findings on the cause of the damage to at least four homes.

``We were working for insurance companies, and they wanted certain results,'' says Overstreet, who has been a licensed civil engineer since 1981. ``They wanted to get a desired outcome, and that's what they did.''

Overstreet, who was working for Houston-based Rimkus Consulting Group Inc., prepared a report on the Gulfport, Mississippi, home of Hubert and Joyce Smith for Meritplan Insurance Co. The engineer found that both wind and water had damaged the house.

``The winds out of the east would have racked the entire structure to the west and simply lifted the footings up,'' he wrote.

Rejected

Meritplan declined to pay anything to the Smiths, telling them that all of the damage was caused by water. The company sent the Smiths what it said was Overstreet's engineering report.

``Due to the extent of the structural damage to the residence, the storm surge accounted for the damage,'' the report they got said.

The Smiths called Overstreet and asked him to look at what Meritplan had sent them. Overstreet says he looked at both reports side by side and then told the couple that someone had changed his conclusion after his inspection.

``If they defrauded me, how many more did they defraud?'' asks Hubert Smith, 88, a retired chiropractor. ``There's a lot of crap going on.''

Six lawsuits against Rimkus allege the company altered engineering reports. ``Those allegations are absolutely false,'' says Arch Currid, a Rimkus spokesman. ``There's no fact to those claims. We're going to vigorously defend ourselves in court, and we're confident we will prevail.''

Lawsuit Settled

Ed Essa, a spokesman for Calabasas, California-based Countrywide Financial Corp., the parent of Meritplan, says the company confidentially settled a lawsuit with the Smiths in March.

Another engineer involved in Katrina, Bob Kochan, CEO of Forensic Analysis & Engineering Corp., says State Farm asked him to redo his reports because the insurer disagreed with the engineers' conclusions. Kochan sent an Oct. 17, 2005, e-mail to his staff saying State Farm executive Alexis ``Lecky'' King asked for the changes.

``Lecky told me that she is experiencing this same concern with other engineering companies,'' Kochan wrote. ``In her words, `They are all too emotionally involved and working too hard to find justifications to call it wind damage.'''

Kochan says he complied so State Farm didn't cut its contract with his company. ``They didn't like our conclusions,'' he says. ``We agreed to re-evaluate each of our assignments.''

`Serious Concern'

Randy Down, an engineer at Raleigh, North Carolina-based Forensic, wrote this Oct. 18, 2005, e-mail response to Kochan: ``I have a serious concern about the ethics of this whole matter. I really question the ethics of someone who wants to fire us simply because our conclusions don't match theirs.''

The e-mails were made public in a civil case against State Farm in Jackson, Mississippi.

State Farm spokesman Phil Supple says Kochan's e-mail comments are out of context. He says sometimes information in engineering reports doesn't support the conclusions.

One State Farm policyholder in Mississippi was Senator Lott, who lost his home in Katrina. He sued

State Farm for fraud in U.S. District Court in Jackson, after the insurer ruled that his home had been damaged by water and refused to pay him anything.

``It's long overdue for this industry to be held accountable'' Lott, 65, says. Lott and State Farm agreed to a confidential settlement in April.

Trent Lott's Bill

Lott has introduced legislation to have insurers regulated by the federal government. That would supplant a patchwork system of regulation by states. Insurance has no body analogous to the SEC, which can refer cases to the Justice Department for criminal prosecution.

That doesn't happen with insurers. The most that state insurance departments typically do is impose civil fines when companies mistreat customers. Such sanctions are weak and infrequent, says Hunter, the former Texas insurance commissioner.

Before Katrina, no state or federal prosecutor had ever investigated a nationally known property-casualty company for criminal mistreatment of policyholders. Mississippi Attorney General Jim Hood says a federal grand jury is probing insurance company claims handling after the hurricane.

There was no criminal investigation after State Farm offered just 15 percent of replacement costs to Michele and Tim Ray, whose house was wrecked by a tornado in April 2006. A contractor estimated the cost to rebuild the Hendersonville, Tennessee, home at $254,000.

Living Amid Ruins

State Farm made three inspections of the property, Ray says, and sent the Rays a check for $36,000, which the couple returned. A year after the twister, the couple remained in the damaged home, with their tattered roof covered by tarpaulins.

In April, after Bloomberg News submitted questions to State Farm about the Ray case, the company inspected the house again. This time, it gave the Rays $302,000.

``We decided to call it a total loss and agreed to pay the policy limits after deciding the damage was caused by the storm,'' State Farm spokesman Shawn Johnson says.

State Farm won't discuss what role McKinsey played in helping the insurer shape its approach toward customers. Similarly, no official at any insurer that hired McKinsey is willing to talk about the consulting firm.

`Doing What is Right'

Privately held McKinsey, which has 14,000 employees in 40 countries, has worked for many of the largest companies in the world, according to its Web site. ``We take pride in doing what is right rather than what is right for the profitability of our firm,'' Managing Director Ian Davis says in a quote posted on the site.

McKinsey pioneered the overhaul of the property-casualty industry at Allstate. The company hired McKinsey in 1992 after the insurer was spun off from what's now Sears Holdings Corp. of Hoffman Estates, Illinois, says David Berardinelli, a Santa Fe, New Mexico, lawyer who won access to view the McKinsey documents for a limited time during a lawsuit involving an auto accident.

McKinsey advised the insurer to pay claims quickly at low amounts while delaying payments for as long as possible for those who wanted large settlements, Berardinelli says. ``They're capitalizing on the vulnerability of people'' he says.

Berardinelli says McKinsey suggested that Allstate hold so- called town hall meetings with claims adjusters to urge them to pay less to customers.

Shannon Kmatz, a former Allstate claims adjuster, says she attended some of those sessions. She says managers told employees to keep claim payouts as low as possible.

Looking at Stock Price

``The leaders of those town hall meetings were always concerned that we were doing our part to help the stock price by keeping claims down," says Kmatz, 34, who worked for Allstate for three years in New Mexico in the late 1990s and is now a police officer. ``It was obvious from the get-go that all they were concerned about was the bottom line."

Just once, at the May 2005 hearing in Lexington, Kentucky, the PowerPoint slides McKinsey prepared for Allstate were made public. William Hager and his wife, Geneva, who suffered neck and back injuries after the family's car was rear-ended in a 1997 accident in Lexington, sued the insurer, claiming the company failed to cover her medical expenses.

The case is scheduled to go to trial in October.

One McKinsey slide prepared for Allstate was called ``Zero- Sum Economic Game," a videotape of the court hearing shows. The slide explains that there are winners and losers, and the insurance company can win by paying out small amounts.

`Finite Pool of Money'

``There is a finite pool of money," Golden, the plaintiffs attorney, told the judge at the hearing. ``Either it goes to the injured victim or it goes to Allstate's pocket as surplus."

Allstate's attorney at the hearing, Mindy Barfield of Lexington, didn't say anything about the McKinsey slides. She didn't return phone calls seeking her comments.

Former federal flood insurance commissioner Hunter says the McKinsey approach exploits policyholders.

``McKinsey presented it as a zero-sum game in which the winners would be Allstate and the losers would be the claimants," Hunter says. ``I don't think a claims system should be viewed in that light. It's against any principles on how you should settle insurance claims. They should be settled on their merits."

Allstate convinced the judge to seal the McKinsey slides before and after the Lexington hearing. The insurer has resisted attempts to make the consulting firm's work public in courts across the U.S., arguing it contains trade secrets.

In 2004, the company was sanctioned by the Bartholomew Circuit Court in Indiana and fined $10,000 for refusing to turn over the records to attorney Richard Enyon, representing an auto accident victim. Allstate held on to the documents and appealed the punishment. The 7th Circuit Court of Appeals upheld the sanction.

`Go To Court'

Allstate then appealed to the Indiana Supreme Court, which hasn't yet made a decision.

Lawsuits in California, Florida and Texas have asserted that McKinsey's work for Allstate helped the insurer cheat claimants. Records show that through the company's Claim Core Process Redesign project, Allstate encouraged policyholders to accept small settlements on the spot.

The redesign also became a blueprint for fighting more claims in court as Allstate increased its legal staff, according to a 1997 company newsletter obtained by David Poore, a Petaluma, California, attorney who has represented homeowners in lawsuits against carriers.

``The bottom line is that Allstate is trying more cases than ever before," the newsletter said. ``If the offer is not accepted, Allstate will go to court, if necessary, to prove the evaluation process is sound."

San Diego Fire

McKinsey-style tactics have spread to insurers large and small, as homeowners discovered after three wildfires ravaged Southern California in 2003, including the one that hit northern San Diego.

While Katrina struck thousands of low-income families in New Orleans, the San Diego fire affected mostly affluent homeowners, who fared no better with their insurance companies.

The fire obliterated large sections of Scripps Ranch, a community of 30,000 that sits atop a sagebrush and eucalyptus mesa, where homes can cost more than $1 million.

After flames swept through the area on winds of up to 50 miles per hour, residents say they expected their insurance companies to live up to coverage promises and pay the full cost to rebuild.

The Southern California fires led to 676 formal complaints to the state saying insurers offered payouts that fell far short of actual costs and delayed on paying claims.

No Inkling

One of the Scripps Ranch houses that went up in flames, a four-bedroom, gray-stucco home on a sloping cul-de-sac, belonged to J.P. Lapeyre, a division director at JDS Uniphase Corp., a Milpitas, California, maker of telecommunications equipment.

Lapeyre, 41, who is married and has two children, says he had no inkling as he viewed the remains of his house that his insurance would leave him $280,000 short of what he would need to rebuild.

Representatives of Pacific Specialty Insurance Co. of Menlo Park, California, told him the most the firm would pay out was $168,075, not even half of the estimated reconstruction cost of $448,000.

The Pacific Specialty representative told Lapeyre in November 2003 that the insurer would pay $75 a square foot (0.09 square meter) to rebuild his 2,241-square-foot house. ``What frustration,'' Lapeyre says. ``I had to try to prove to them that it would cost $200 a square foot.''

That figure came separately from two builders, Norton Construction and TLC Contractors, both of San Diego.

Lapeyre's Suit

In February 2005, Lapeyre filed suit in San Diego County Superior Court against his insurer and the independent broker who sold him the policy, alleging negligence, breach of contract and fraud for leading him to believe that he was properly covered.

After a fight of 19 months, Lapeyre dropped the suit when Pacific Specialty told a mediator assigned to the case it wouldn't raise its offer, he says. ``We decided it was time to get on with our lives and move forward,'' says Lapeyre, who borrowed money to build a new house.

Karen and Bill Reimus, both lawyers, fought their carrier, Liberty Mutual Insurance Co., when it told them it wouldn't pay the couple enough to rebuild their burned Scripps Ranch house.

Karen, 40, says an agent for Boston-based Liberty Mutual assured her and her husband when they bought their house four months before the 2003 fire that their insurance would replace the home if it were destroyed.

`A Low Ball'

In a December 2003 letter, two months after the fire, Liberty Mutual offered to pay $40,000 less than the limit of the couple's policy, Karen says. In early 2004, San Diego-based Gafcon Construction Consultants determined the cost to rebuild was well above the limits of the couple's policy.

The Reimuses began a phone and letter campaign to convince the company its offer was too low, Karen says. ``It has now been almost seven months since the loss and we are still not agreed as to the numbers,'' Karen wrote in a May 13, 2004, letter to Liberty Mutual.

Two weeks later, Liberty Mutual agreed to raise the couple's limits by $100,000, Karen says. ``This is clear evidence that the original estimate was a low ball,'' she says.

Liberty Mutual spokesman Glenn Greenberg says the company won't discuss the case because its dealings with policyholders are private.

``The system is set up to take advantage of people when they're at their weakest,'' Karen says. ``We went to one of the most-expensive companies in the country because we wanted to be ready for a rainy day. We asked for coverage that would replace the house. We thought replacement meant replacement."

Allstate Suit

Scripps Ranch couple Leslie Mukau and Robin Seaberg sued Allstate for alleged fraud and negligence for failing to pay the $900,000 that contractors estimate it would cost to replace their two-story home.

Allstate offered the Seabergs $311,000, according to the 2004 San Diego County Superior Court suit. Allstate says in court papers the couple hasn't shown the company was negligent and asked for dismissal of the suit, which is pending.

The California Department of Insurance examined the practices of Allied Property & Casualty Insurance Co., AMCO Insurance Co. and Allstate in connection with the California fires.

It fined Allied and AMCO, both based in Des Moines, Iowa, a total of $20,000 for misleading nine policyholders into believing they were insured for full value. The regulators cited Allstate for six rule violations, including that it ignored complaints that it underinsured homeowners.

Fines `Too Small'

The state didn't fine Allstate, which told the department it had done nothing wrong.

``Fines by state regulatory agencies have been far too small and infrequent to deter unfair business practices,'' United Policyholders' Bach says. ``It's clear that cheating by insurers is a big, profitable business and regulators can't muster the will or political strength to stop them.''

Most homeowners take what insurers offer because they don't realize they're being deceived or conclude that fighting is too costly and difficult, Bach says.

``Virtually everyone who settles for what the insurer offers is taking less than they're owed,'' she says.

Homeowners across the U.S. have found themselves in the same situation. Kevin Hazlett, a lawyer, sued Farmers Group after an April 2006 tornado struck his home in O'Fallon, Illinois.

`Thin Air'

Farmers had offered to pay him $470,000 to rebuild the house. Royal Construction Inc., based in Collinsville, Illinois, estimated the cost at $1.1 million. Hazlett, 52, accepted a settlement for an undisclosed amount.

Hazlett says Illinois Farmers, a subsidiary of Farmers, used the Xactimate software program to first determine what it would pay out. ``They're just pulling numbers out of thin air,'' he says. ``There's no rhyme or reason.'' Farmers spokesman Jerry Davies didn't respond to requests for an interview.

Bo Chessor, owner of Royal Construction, says he sees insurers refusing to pay coverage limits all the time. ``Most people just roll over and take it because they don't have the money to fight it,'' Chessor says. ``What the insurance companies are doing is purely robbery.''

It may be robbery, but it's rarely a crime. State insurance departments don't prosecute insurance companies, and the federal government has no oversight. The insurance industry wants to keep it that way.

Insurance Lobbying

To make their voice heard on federal regulation and other government decisions, insurers spent $98 million on lobbying in Washington in 2006, according to PoliticalMoneyLine, a unit of Congressional Quarterly. That's the second-largest amount spent on lobbying by any group, behind $114.4 million by pharmaceutical companies.

Property-casualty companies do want something from the government: bailouts. Insurers beseech states and the federal government to foot more of the bill for rebuilding private homes after natural disasters.

Florida has a catastrophe fund that insures some homes to reduce payouts by carriers. The fund paid out about $8.45 billion for storm damage in 2004 and 2005, according to its annual report. The federal flood insurance program covers $800 billion of property nationally, which helped the industry increase profits by 25 percent in 2005, the year of Katrina.

Disaster Just the Beginning

Homeowners whose properties have been destroyed by catastrophes contend with low payouts, higher premiums, software programs that underestimate rebuilding costs and sudden changes in policy values -- all of which have been calculated methods for insurers to increase profits.

Tunnell, the San Diego accounting teacher whose home burned to the ground, says she thought State Farm had adequately insured her family when they bought their three-bedroom house in 1992. She says the policy, destroyed in the fire, provided for ``full replacement coverage.''

It guaranteed to rebuild the house, no matter the cost, she says. The company offered to pay $220,000 -- which was $86,000 less than a $306,000 figure her family got from State Farm's own estimator, Hersum Construction Inc. of San Diego, for rebuilding the 1,700-square-foot house.

State Farm spokesman Supple says the company sent letters in 1997 to the Tunnells and other policyholders saying that it would no longer offer full replacement coverage. ``Policyholders, by regulatory order, were sent prominent notices of the coverage change at that time,'' he says.

`This is Unthinkable'

Tunnell says she doesn't recall being notified. She says her family debated hiring a lawyer and suing, and eventually decided the battle would be too stressful. The Tunnells took the $220,000 and borrowed money to build a new house.

``Why is this happening to people over and over again?'' Tunnell asks. ``State Farm keeps underinsuring people, and they get away with it. This is unthinkable.''

As long as insurers make the rules and control the game, Tunnell and homeowners across the U.S. won't know whether their homes are fully insured, no matter what their policies say.

To contact the reporters on this story: David Dietz in San Francisco at **ddietz1@bloomberg.net** ; Darrell Preston in Dallas at **dpreston@bloomberg.net** .

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Statement of Suzanne Ross McDowell
Steptoe & Johnson LLP

Testimony Before the
Committee on Finance
United States Senate

Offshore Tax Issues: Reinsurance and Hedge Funds

September 26, 2007

Mr. Chairman and Members of the Committee:

My name is Suzanne Ross McDowell. I am a partner in the law firm Steptoe & Johnson LLP in Washington, D.C. My practice focuses on the law of tax-exempt organizations with particular emphasis on tax, corporate governance, and commercial transactions. From 1983 to 1987, I served in the Office of Tax Policy at the U.S. Department of Treasury and was responsible for issues relating to tax-exempt organizations, including issues related to the debt-financed income rules. Since leaving the Treasury Department, I have written academic papers and given presentations on the debt-financed income rules and numerous other topics relevant to tax-exempt organizations.[1] The views I am expressing are my own and do not represent the views of my law firm, any client or any other organization.

My testimony today will focus on the unrelated debt-financed income rules. These rules impose a tax on investment income of an exempt organization that would otherwise be tax-exempt solely because the exempt organization uses debt to acquire the property that produces the income.[2] To avoid the tax imposed by the debt-financed income rules, exempt organizations often use so-called blocker entities to acquire investments. Generally speaking, a blocker entity is a corporate entity formed in a low-tax jurisdiction that is interposed between an investment and the exempt organization. The corporation "blocks" the attribution of any debt to the exempt organization, and thus enables the exempt organization to avoid the application of the debt-financed income rules. My testimony will cover the history and purpose of the rules, the types of transactions they discourage, and the policy concerns that should be considered by Congress in the course of its evaluation.

Legislative History and Current Law

Tax-Exempt Status of "Passive Income." Since 1950, tax-exempt organizations have been subject to the unrelated business income tax ("UBIT") on income from businesses that are not related to their exempt functions. When Congress enacted the UBIT, it excluded certain types of investment income -- commonly referred to as "passive income"-- from the tax. Specifically, dividends, interest, royalties, annuities, most rents, and capital gains and losses were not subject to UBIT.[3] In the years since the enactment of the UBIT, exceptions have been added for payments with respect to securities loans,[4] loan commitment fees,[5] and income from the lapse or termination of options.[6] According to the legislative history, Congress excluded these types of income from UBIT because it did not think they posed serious competition for taxable businesses and because such income had long been recognized as a proper source of revenue for educational and charitable organizations.[7]

Unrelated Debt-Financed Income Rules. The exclusion for "passive income" does not apply to the extent that such income is derived from debt-financed property.[8] In other words, income earned by an exempt organization from debt-financed property is subject to tax. Property is treated as debt-financed if indebtedness is incurred before or after the acquisition or improvement of the property that would not have been incurred but for such acquisition or improvement.[9] The portion of income that is subject to tax is the fraction equal to the average acquisition indebtedness for the year over the average adjusted basis of the property for the year.[10]

The debt-financed income rules were passed in 1969 to foreclose abusive sale-leaseback transactions. In such transactions, a charitable organization would acquire property (usually real estate) from a taxable business, often borrowing to finance the entire purchase price. As a condition of the sale, the exempt organization would lease the property back to the seller on a long-term basis. The exempt organization would repay the loan, plus interest, with the lease payments or "rental payments" received from the seller-lessee. The exempt organization would receive both (i) the difference between the "rental payments" and the sale price and (ii) outright title to the property, all without investing or risking much, if any, of its own funds. The seller would obtain capital gain treatment for the sale price received and large deductions against taxable income for the "rental payments" made, all while continuing to operate its business using the property in the same manner as before.[11]

Application of Unrelated Debt-Financed Income Rules to Securities and Financial Products. The debt-financed income rules have been challenging to apply to securities and other financial products. Neither the Internal Revenue Code (the "Code") nor the Treasury regulations thereunder define "indebtedness" for purposes of the debt-financed income rules. Consequently, in determining whether a particular transaction creates indebtedness and therefore is subject to tax, the Internal Revenue Service and the courts have looked to common law definitions of indebtedness and definitions in other parts of the Code. The result has been that the rules have been applied in a formalistic manner. Generally, when a tax-exempt investor borrows funds and has a clear obligation to repay the funds, the debt-financed income rules are applicable. Thus, securities purchased on margin have been held to be debt-financed property.[12]

A pension plan that used a certificate of deposit ("CD") with a low interest rate as collateral to borrow funds to acquire a new CD with a higher interest rate was subject to UBIT on the new CD because it was purchased with borrowed funds.[13] In this case, the pension fund was not seeking to leverage its investment. It simply wanted to avoid incurring penalties for early redemption of the low-interest CD, while at the same time reaping the benefits of an increase in interest rates. Similarly, the withdrawal of the accumulated cash value of life insurance policies for the purpose of investing the funds in property with a higher rate of return has been held to create acquisition indebtedness and, therefore, is unrelated debt-financed income when such withdrawals are used to purchase securities.[14]

In contrast to the above examples, many transactions that do not involve debt in the traditional sense of borrowing funds and incurring an obligation to repay the funds, but do involve leverage, are not subject to the debt-financed property rules. In many cases, because the transactions were not clear cases of borrowing, the IRS relied on Congressional intent to exclude investment income from tax in reaching its conclusion that the debt-financed income rules do not apply. Thus, securities lending transactions,[15] short sales of stock,[16] commodities futures contracts,[17] securities arbitrage transactions[18] and notional principal contracts[19] are not treated as debt-financed property and are not subject to UBIT.

Limited Exception for Real Estate. Income earned from real estate is excluded from the unrelated debt-financed income rules under a limited exception, but only if certain conditions are satisfied.[20] Additionally, the exception only applies to real property acquired by pension trusts, schools, colleges and universities. To qualify for the exception, the real estate transaction cannot have certain characteristics of the sale-leaseback transactions that were the target of the rules when first enacted. Thus, for example, the transaction cannot involve (i) seller financing;

(ii) indebtedness determined by reference to income from the property; or (iii) a lease back to the seller.[21] Additionally, in the case of real estate investments made by partnerships, the exception is limited to transactions that do not permit tax-exempt partners to transfer tax benefits to taxable partners.[22] Certain of these rules that limit the exception for real estate partnerships, most notably the so-called "Fractions Rule," are exceedingly complex and difficult to apply in practice.[23]

"Blocker Entities." The unrelated debt-financed income rules can be avoided on securities and financial products by investing through foreign corporations referred to as "blocker entities." A blocker entity is a foreign corporation usually established in a low tax jurisdiction. The tax-exempt investor invests in the foreign corporation and the foreign corporation in turn invests in a hedge fund or other similar debt-financed investment. Income from the hedge fund or other investment is distributed to the foreign corporation, which pays little or no tax on the income as a result of the jurisdiction in which it is established. The foreign corporation in turn pays the income to the tax-exempt investor as a dividend. Because dividends are not subject to UBIT, the income from the hedge fund is not taxable to the tax-exempt investor and the debt-financed income rules are avoided. Most hedge funds are partnerships and, in the absence of the blocker entity, debt-financed income would be passed through to the tax-exempt investor as debt-financed income and would be subject to tax.[24] The Service has issued private letter rulings upholding the treatment of income received from a foreign corporation used as a blocker entity as a dividend that is not subject to UBIT.[25]

Other Ways to Avoid Debt-Financed Income. Blocker entities are not the only way to avoid the unrelated debt-financed income rules. The unrelated debt-financed income rules can also be avoided through contractual arrangements. In private letter rulings, the Service has held charitable remainder trusts did not have unrelated debt-financed income when they had a contractual right to income based on an educational institution's endowment even though the endowment had some unrelated debt-financed income. The educational institution, which was the charitable beneficiary of the trust entered into a contract with the trust giving it a right "units" that were tied to the value of the institution's endowment. The units entitled the charitable remainder trust to periodic income equal to the payout rate of the institution's endowment and the units could be redeemed for amounts based on the value of the endowment.[26]

Additionally, the unrelated debt-financed income rules do not apply to an investment in a mutual fund that purchases securities and financial products that would be treated as debt-financed property if purchased directly by the exempt organization or through a partnership. Similarly, investment in debt-financed property through a real estate investment trust ("REIT") generally does not result in income subject to UBIT.[27] In addition, investment through a variable contract with an insurance company tied to a segregated asset account that includes investments that would be treated as debt-financed property if purchased directly by the exempt organization or by a partnership in which the exempt organization is a partner is generally not subject to UBIT.[28]

Discussion

At first blush, blocker entities may appear to be a "loophole" that should be shut down. However, blocker entities are frequently used to avoid the application of the unrelated debt-financed income rules to transactions that were never intended to be within the scope of the rules. Thus, before taking action on blocker entities, Congress should re-evaluate the policy and impact of the unrelated debt-financed income rules.[29]

The unrelated debt-financed income rules tax all debt-financed investments of tax-exempt organizations, although they were enacted to foreclose abusive sale leaseback transactions. The current breadth of application would be justified only if all leveraged investments of tax-exempt investors should be discouraged. The purpose of leverage is to increase the investor's return on investment. The trade-off for the increased return is taking on greater risk.[30] The increased risk of an individual investment, however, can be reduced through diversification in the investor's portfolio and by hedging. Furthermore, investments that do not use leverage may be as risky or riskier than leveraged investments. Thus, taxing all debt-financed income is not an effective way to protect tax-exempt investors from risk.

Moreover, the level of risk assumed by tax-exempt organizations is already addressed by various other laws that create legal standards for permissible investments of tax-exempt organizations. At the federal level, investments of private foundations are subject to the jeopardizing investment rules of Code section 4944 and pension funds are subject to the fiduciary standards of ERISA.[31] At the state level, directors of nonprofit corporations must adhere to the common law duties of care and loyalty. Additionally, most states have adopted the Uniform Management of Institutional Funds Act (UMIFA), which provides uniform rules governing the investment of endowment funds held by charitable institutions.[32] UMIFA was approved by the National Conference of Commissioners on Uniform States Laws (NCCUSL) in 1972, and established a standard of business care and prudence in the context of the operation of a charitable institution. Prior to UMIFA, each investment of a charitable institution was evaluated separately, an approach that led directors of charities to feel compelled to limit investments to fixed income investments and dividend-paying stocks. UMIFA changed the law to permit an approach that is more in line with modern portfolio management theories, looking at the portfolio as a whole rather than investment by investment.[33] In 2006, the NCCUSL further modernized the standards applicable to charitable institution fund management and approved a revision of UMIFA entitled the Uniform Prudent Management of Institutional Funds Act (UPMIFA).[34] UPMIFA expanded the application of UMIFA to charitable trusts and incorporated the more modern standards of the Uniform Prudent Investor Act passed by NCCUSL in 1994. UPMIFA provides that, "[m]anagement and investment decisions about an individual asset must be made not in isolation but rather in the context of the institutional fund's portfolio of investments as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the fund and to the institution."[35]

In summary, debt financing increases the risk of an individual transaction, but that is not a reason to discourage all debt financing without regard to the level of risk and return of a charitable institution's investments as a whole, as the debt-financed income rules do. Moreover, the debt-financed income rules are unnecessary for this purpose because other laws govern investment standards with a more nuanced and aggregate approach that is consistent with modern investment theory.

An additional problem with the debt-financed income rules is that they have been applied in a rigid manner that makes formalistic distinctions between debt and leverage. As described above, the result is that the rules tax transactions which involve direct borrowing while permitting investors who use leverage in more sophisticated transactions to escape tax.

Recommendations

Rather than focusing on the use of blocker entities to avoid the unrelated debt-financed income rules, I urge Congress to evaluate the operation of the debt-financed income rules and to significantly restrict the application of these rules. Under current law, there is an exception for real estate transactions of pension funds and universities if the transactions meet certain requirements. This exception, and its requirements, should be used as the model for a broader exception applicable to all types of debt-financed property and available to all tax-exempt organizations.

First, the exception should not be limited to pension funds and universities. While some tax policy argument may exist that pension trusts are uniquely focused solely on investments and are therefore distinct from other exempt organizations, a similar argument cannot be made to distinguish colleges and universities from other tax-exempt organizations. Therefore, exceptions to the debt-financed income rules should apply to all tax-exempt organizations.

Further, the exception should not be limited to real estate. As discussed above, the current debt-financed income rules apply to many legitimate investment transactions that are not abusive and were not the intended target of the rules. The current real estate exception includes requirements that (i) the indebtedness be for a fixed amount; (ii) the seller not provide financing; and (iii) the lender not have the use of the property. These requirements should be retained as a condition to a new broader exception that applies to all debt-financed property.

Finally, the current real estate exception includes restrictions applicable to investments made through partnerships which are intended to prevent the transfer of tax benefits from tax-exempt partners to taxable partners. These restrictions are tailored to real estate transactions and do not lend themselves to application to investments in other property such as securities and other financial products. Although I am not aware of hedge funds and other investment partnerships being used to transfer tax benefits from tax-exempt partners to taxable partners, nevertheless, Congress should give the Treasury authority to promulgate regulations in the future if necessary to foreclose such transfers in non-real estate partnerships.

Conclusion

If Congress amends the unrelated debt-financed income rules as suggested, tax-exempt investors would no longer be forced to invest offshore and use blocker entities to avoid the unrelated debt-financed income rules on legitimate investments. Further, the current disparate treatment between direct borrowing and leverage, and between different types of tax-exempt investors, would be eliminated.

I would be pleased to respond to your questions.

Endnotes

[1] *Taxing Leverage Investments of Charitable Organizations: What is the Rationale?*, 39 Case W. Res. L. Rev. 705 (1988); *Taxation of Unrelated Debt-Financed Income*, 34 Exempt Org. Tax Rev. 197 (2001).

[2] IRC § 512(b)(4); 514(a)(1).

[3] IRC §§ 512(b)(1), (2), (3), (5).

[4] IRC § 512(b)(1), (a)(5).

[5] IRC § 512(b)(1).

[6] IRC § 512(b)(5).

[7] H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38-40 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 30-31, (1950).

[8] Section 514 applies to all debt-financed property but contains several exceptions which have the collective effect of generally limiting its application to investment income. See §§ IRC 514(b)(1)A) - (E), 514(b)(3); 514(c)(2), (4), (5), (6), (8).

[9] IRC § 514(c)(1).

[10] IRC § 514(a)(1).

[11] S. Rep. No. 552, 91st Cong., 1st Sess. 62-63, *reprinted in* 1969 U.S.C.C.A.N. 2027, 2091-92; H.R. Rep. No. 413, 91st Cong., 1st Sess. 44-46, *reprinted in* 1969 U.S.C.C.A.N. 1645, 1690-91.

[12] *See, e.g., Elliott Knitwear Profit Sharing Plan v. Comm'r*, 614 F.2d 347 (3d Cir. 1980), *Alabama Central Credit Union v. United States*, 646 F. Supp. 1199 (N.D. Ala. 1986); *Ocean Cove Corporation Retirement Plan v. United States*, 657 F. Supp. 776 (S.D. Fla. 1987); *Henry E. & Nancy Horton Bartels Trust for the Benefit of the University of New Haven v. United States*, 209 F.3d 147, 156 (2d Cir. 2000).

[13] *See Kern County Electrical Pension Fund v. Comm'r*, 96 T.C. 845 (1991).

[14] *Mose & Garrison Siskind Memorial Foundation Foundation v. United States*, 790 F.2d 480 (6th Cir. 1986).

[15] Rev. Rul. 78-88, 1978-1 CB 163.

[16] Rev. Rul. 95-8, 1995-1 CB 107. *See also* PLR 9637053 (Sept. 13, 1996); PLR 9703027 (Jan. 17, 1997).

[17] Gen. Couns. Mem. 39620 (April 3, 1987).

[18] Gen. Couns. Mem. 39615 (March 23, 1987).

[19] Treas. Reg. § 1.512(b)-1(a)(1).

[20] IRC § 514(c)(9).

[21] IRC § 514(c)(9)(B)(i)-(v).

[22] IRC § 514(c)(9)(B)(i)-(v).

[23] IRC § 514(c)(9)(E).

[24] IRC § 512(c).

[25] Priv. Ltr. Rul. 199952086 (Sept. 30, 1999).

[26] *See* Priv. Ltr. Rul. 200352017 (Oct. 3. 2003); Priv. Ltr. Rul. 200352018 (Oct. 3, 2003); Priv. Ltr. Rul. 200703037(Oct. 23, 2006); Priv. Ltr. Rul. 200703038 (Oct. 23, 2006). The Service also ruled that a charitable lead trust could avoid unrelated debt-financed income through a similar contractual arrangement but later limited the application of the ruling to funds that had already been invested in the endowment through the contractual arrangement. *See* Priv. Ltr. Rul. 200352019 (granting ruling to charitable lead trust); Priv. Ltr. Rul. 200702036 (Oct. 17, 2006) (limiting the application of Priv. Ltr. Rul. 200352019). The clarifying ruling indicated that the Service is concerned about inappropriate benefits to non-charitable beneficiaries because in a charitable lead trust, the charity receives the income for a term of years and then a non-charitable beneficiary receives the remainder interest. The Service stated that it is studying whether a charitable lead trust should realize UBIT on the transaction.

[27] Note, however, that by definition a REIT must have 100 or more shareholders, a requirement that makes a REIT a less attractive alternative investment vehicle. In addition, section 856(h)(3)(C) recharacterizes dividends from a REIT in certain circumstances on a look-through basis if the REIT is "predominantly held by qualified trusts."

[28] Note, however, that if the segregated asset account is not adequately diversified within the meaning of section 817(h), certain look-through rules apply and may result in UBIT.

[29] In the 1980s, blocker entities were used to avoid UBIT on offshore captive insurance companies. *See* Priv. Ltr. Rul. 8819034 (Feb. 10, 1988). In response, Congress added Section 512(b)(17)(A) to the Code, providing that foreign source income from offshore captive insurance companies is taxable. Small Business Job Protection Act of 1996, Pub. L. 104-188, section 1603(a). Those cases, however, involved the operation of an active unrelated business—an activity that the UBIT is clearly intended to tax.

[30] For example, if an investor buys $100,000 worth of stock and the value of the stock increases by 10 percent in one year, the investor has earned $10,000. If this same investor borrowed another $100,000 at 8-percent interest and invested $200,000 in the same stock, it

would earn $20,000 on the stock and, after paying $8,000 in interest on its debt, would net $12,000, an increase in its rate of return from 10 percent to 12 percent. Of course, if the $200,000 in stock did not earn at least $8,000 to cover the interest payment, the investor would have a loss. Thus, the leveraged investment is riskier because the return on the investment must be at least 4 percent for the investor to avoid a loss.

[31] Employee Retirement Income Security Act, Section 404 29 U.S. C. 1104.

[32] According to the NCCUSL, UMIFA has been adopted in 47 states.

[33] When originally passed, UMIFA did not apply to charitable trusts. In 1992, the *Restatement (Third) of Trusts* adopted standards similar to UMIFA and reformulated the Prudent Man Rule to provide that borrowing is permissible if the tactic is "employed selectively and cautiously." *See* Restatement (Third) of Trusts (The Prudent Investor Rule), § 227 (1992). Two years later, the NCCSL approved the Uniform Prudent Investor Act and incorporated the principles of the Restatement and principles of modern portfolio management. As described above, these standards were further incorporated into UPMIFA in 2006.

[34] According to NCCUSL, UPMIFA has already been adopted by 13 states.

[35] UPMIFA § 3(e)(2).

Questions for the Record for Suzanne McDowell
Offshore Tax Issues
September 26, 2007

Questions From Senator Grassley

1. The so-called "fractions rule" was adopted to prevent abuse of a charity's tax exemption where a charity is a partner in a partnership that allocates disproportionally large amounts of the partnership's depreciation deductions to taxable partners in the early years of the partnership or that similarly allocates disproportionally large amounts of its income to charitable partners. What would prevent such abusive allocations if the "fractions rule" were repealed?

Senator Grassley, if the Fractions Rule was repealed, the substantial economic effect test would be the primary provision of the Code that would prevent abusive allocations. Some commentators have argued that changes in the law since the enactment of the Fractions Rule have decreased the potential for abuse. Additionally, the potential for abuse in securities and commodities investment partnerships may be less than the potential for abuse in real estate partnerships because depreciation deductions are not applicable to securities and commodities.

2. Some groups, such as the Tax Section of the New York State Bar, have suggested that the "fractions rule" can be replaced by a rule that would not honor disproportional allocations of deductions or income of partnerships with tax-exempt partners if the intent of making such allocation was tax avoidance. What types of evidence would the IRS agent need to find in order to establish that such tax avoidance motive was present? Do you believe that the IRS could fairly and easily administer such an intent rule so as to prevent significant abuse in light of the limited audit resources of the IRS?

Senator Grassley, whether a tax avoidance motive is present depends upon an examination of all the facts and circumstances. The presence or absence of legitimate business purposes is a key factor in determining whether a transaction was entered into with a primary purpose of tax avoidance. Whether similar allocations are found in partnerships that do not include tax-exempt investors would be one indication of a legitimate business purpose for an allocation. The general rule in tax law is that the burden is on the taxpayer (or, in this case, the exempt organization) to sustain its position. Thus, an exempt organization would need to show there was a legitimate business purpose for an allocation if the IRS took the position that the allocation was motivated primarily by tax avoidance.

From the standpoint of tax administration, bright line rules are preferable for both taxpayers and the IRS. However, workable bright line rules that strike the right balance between prevention of abuse and minimizing undue burdens on legitimate economic transactions are sometimes difficult to draft. For this reason, many parts of the tax law turn on whether the taxpayer has a primary purpose of tax avoidance. For example, the current regulations under section 514 relating to tiered partnerships contain provisions that turn on the presence of tax avoidance.

Additionally, the tax treatment of many corporate transactions and financing transactions turn on whether the taxpayer has a tax avoidance motive.

Tax practitioners generally feel that the Fractions Rule does not strike the right balance between prevention of abuse and minimizing undue burdens on legitimate transactions. I believe that the New York State Bar Tax Section's point was that, while the Fractions Rule may prevent any conceivable abuse, it exacts too high a price from the vast numbers of exempt organizations and pension funds that seek to make legitimate and sound investments. In such situations, a rule based on whether the purpose of the transaction was tax avoidance deserves consideration.

The IRS has substantial experience with rules based on tax avoidance and I do not think it would be any more difficult for it to administer such a rule in this context than it is in other contexts.

3. The debt-finance rules generally apply to all types of debt-financed property, whether it is real estate, securities, or commodities. You and others have suggested, however, that the primary reason for change in 1969 was to prevent abusive sale-lease back transactions involving real estate, and thus that the rules enacted were overbroad. Do you believe that the debt-finance rules serve no other purpose, for example, to prevent the leveraging of tax-exemption?

Senator Grassley, my reading of the legislative history indicates that Congress enacted the debt-financed income rules because of its concern with abusive sale-lease back transactions involving real estate. In the legislative history to the 1950 legislation which enacted the predecessor to the current rules, Congress identified three principal problems with sale and lease-back arrangements where borrowed funds were used. First, the exempt organization was "trading on its exemption, since the only contribution it [made] to the sale and lease-back was its tax exemption." Second, because exempt organizations could acquire property through lease-backs without investing any of their own funds, exempt organizations could conceivably come to "own the great bulk of the commercial and industrial real estate in the country," resulting in a serious erosion of the corporate and individual income tax base. Third, the exempt organization may have "sold" part of its exemption, either by paying a higher price for the property or by charging lower rents than a taxable business. Two of the three concerns were stated in terms of real estate transactions. While the first concern is not expressly linked to real estate, the provision that was enacted in 1950 applied only to leases of real property (and personal property leased with it). In the legislative history to the Tax Reform Act of 1969, which enacted the current debt-financed income rules, Congress stated that the so-called *Clay Brown* transaction, a type of sale-leaseback transaction, was the reason for the change.

4. If the unrelated debt-finance income tax rules were repealed or substantially modified to extend exempt status to debt-financed income, would you support extending to public charities the present-law excise taxes that apply to private foundations to regulate risky investments, or, relatedly, adoption of a Federal prudent investor standard? In your testimony, you cite state laws, but I have found in practice the enforcement of state laws as to charities to be very rare even on a good day.

Senator Grassley, I agree that resources for enforcement of state laws relating to charities are inadequate and enforcement is close to nonexistent in all but a handful of states. Many commentators and witnesses before this Committee in recent years have stated that resources at the federal level for enforcement of laws relating to charities are also inadequate. This raises the question of whether extension of the private foundation jeopardizing investment rules to public charities or enactment of a federal prudent investor rule would have any significant impact on enforcement actions relating to unduly risky charitable investments. Another concern with enactment of additional rules, as opposed to better enforcement of existing rules is that enactment of additional rules will increase the cost of compliance for charities and thus reduce the amount that is spent on charitable activities. The Pension Protection Act permits increased sharing of information between the states and the IRS. Instead of enacting additional laws, it may be more efficient for the IRS and states to work together on regulating investments or for Congress to consider funding enforcement of certain states laws rather than enacting additional laws. If Congress does decide to enact a law creating a federal prudent investor rule, I urge the Congress to consider building on the Uniform Prudent Management of Institutional Funds Act so that federal law will be similar to the laws in most states.

5. Statistics of Income at the IRS has reported that the collection of UBIT has dropped dramatically over a long period of time. What do you believe are the reasons for that, should Congress be concerned, and what actions do you recommend to ensure that the UBIT is effectively and properly enforced?

Senator Grassley, I do not know the reason for the decrease in collection of UBIT but can theorize as to some possible reasons for the decrease. Some of these reasons would cause concern to Congress and some would not. One possibility is that exempt organizations may be transferring unrelated business activities to taxable subsidiaries. If this is the case, the unrelated businesses are still subject to tax and there is no reason for Congress to be concerned. Another possibility is that more exempt organizations are structuring business arrangements as licensing agreements which produce royalty income which is not subject to UBIT. If this is the case, there is not a compliance issue and Congress has no reason to be concerned. A third possibility is that exempt organizations are allocating more expenses to unrelated business income and thereby reducing UBIT. I do not know if this is the case and, if it is, I do not know whether exempt organizations were overpaying UBIT before or are underpaying now. A fourth possibility is that, due to uncertainty as to whether some business activities are substantially related to an organization's exempt purpose, and lack of enforcement by the IRS, exempt organizations may not be reporting income from activities that when the correct tax treatment is uncertain. This, of course, would be a reason for Congress to be concerned.

Questions From Senator Hatch

1. Ms. McDowell, you recommended in your testimony that the application of the debt-financed income rules be restricted in certain circumstances. In your view, what is the cost of the way the rules are currently applied? And conversely, what might we gain by adopting your recommendations?

Senator Hatch, the primary cost of the current debt-financed income rules is that they tax all debt-financed investments, including many investments that are permissible investments for tax-exempt organizations and pension funds under modern portfolio theory and applicable legal standards. Large tax-exempt investors have avoided the application of the debt-financed income rules through the use of blocker entities and contractual arrangements. Smaller tax-exempt investors most likely do not make debt-financed investments. An additional problem is that the debt-financed income rules have been challenging to apply to transactions in securities and commodities and are generally applied to transactions that involve debt in the sense of a direct borrowing, but are not applied to transactions that involve other types of leverage. This has resulted in disparate treatment of similar transactions and many areas of uncertainty.

If my suggestions were adopted, exempt organizations would not need to resort to offshore blocker entities or contractual arrangements to avoid the debt-financed income rules. Further, the current disparate treatment between direct borrowing and leverage would be eliminated.

2. Ms. McDowell, you mentioned that the debt-financed income rules were enacted to shut down abusive sale-leaseback transactions. Do you believe the rules were effective in doing so? Are there other abuses that these rules preclude?

Senator Hatch, as far as I know, abusive sale-leaseback transactions of the type that were the target of the debt-financed income rules were shut down by the debt-financed income rules. Although it was not the original purpose of the debt-financed income rules, they also preclude abusive allocations in real estate partnerships because the effect of the rules is to tax participation in real estate partnerships, because virtually all real estate partnerships involve debt-financed property. For organizations such as pension funds and universities that qualify for an exception to the rules, the so-called Fractions Rule was an effort to prevent such abusive allocations. However, the Fractions Rule has been widely criticized as being overly complex and burdensome and imposing overly harsh penalties on minor infractions.

TESTIMONY OF

LYNNE MUNSON

ADJUNCT FELLOW
CENTER FOR COLLEGE AFFORDABILITY
AND PRODUCTIVITY
WASHINGTON, DC

Before the

COMMITTEE ON FINANCE

of the

UNITED STATES SENATE

September 26, 2007

Chairman Baucus, Ranking Member Grassley, and members of the committee, thank you for inviting me to testify on the topic of higher education endowments.

I am an Adjunct Fellow at the Center for College Affordability and Productivity, where we conduct research on issues of rising costs and stagnant efficiency in higher education. I served from 2001-2005 as Deputy Chairman of the National Endowment for the Humanities. And I'm also the mother of a one-year-old whose college education will cost a half million dollars if current tuition trends continue.

Senators, our colleges and universities are sitting on some of the largest fortunes amassed by any institutions in the history of our nation. These riches are proof of America's economic strength and of the boundless generosity of its citizens. But I'm afraid to report that, in too many cases, this wealth is being hoarded instead of shared.

College and university endowment spending practices are stuck in a past when endowments were small, investment gains were marginal, and economic rainy days were frequent. Today higher education endowments are massive and—as we've heard today—aggressively invested. Returns often exceed 12% or more year after year. Yet endowment payouts are miserly—averaging just over 4% last year. The situation begs the question: Is the public benefiting enough? Research indicates the answer is "no."

Jane Gravelle points out that endowment wealth is concentrated in the upper ranks, much of it at 62 institutions with endowments larger than $1 billion.[i] But just three years ago only 39 schools had billion-plus endowments. That's a 38% increase in just a few years. In 2006, 125 schools had endowments over $500 million—a third more than in 2002. The number of schools that can count themselves as endowment-rich or super-rich is growing rapidly.

This wealth no longer resides solely or even primarily in the New England corridor. Twenty-six states including Tennessee, Kansas, Minnesota, and Iowa boast institutions with billion-plus endowments. The University of Pittsburgh, Purdue, Michigan State, and little 1500-student Grinnell College each have endowments larger than a billion. A third of the billion-plus endowments are at public institutions, including four of the ten largest endowments.

Some of the most outsized endowments are at elite institutions. Yale has $2.8 million in the bank per undergraduate. But, on average, independent schools with endowments larger than a billion have $432,422 in their endowment per full-time student.[ii] And plenty of public schools also have impressive endowment-to-student statistics. The University of Virginia and the University of Michigan bank $322,000 and $150,000 per undergraduate, respectively. And even though the

9-campus University of Texas system currently enrolls just under 150,000 undergraduates, its massive $13 billion endowment contains $90,000 for each student.

What the data shows is that endowment wealth is everywhere—except in the hands of the students who need it today. Last year endowments increased 17.7% on average—those larger than a billion increased 18.4%.[iii] Yet, despite double-digit increases stretching back a decade or more[iv]—endowment spending is at a nearly all-time low of 4.2%--down from 5.1% in 1994, 6.5% in 1982, and 5.2% in 1975.[v]

Schools often blame low endowment spending on donor restrictions. But 45% of endowment funds are unrestricted at independent institutions—as are 20% at public schools.[vi] And financial aid is the number one restriction designated by donors—with 36% of gifts restricted for financial aid use in 2005.[vii] Yet spending on financial aid is shamefully small, with many schools putting just a fraction of a percentage of endowment value toward aid.

Ms. Gravelle has addressed the issue of how little additional endowment spending would be required to halt tuition hikes. I will not add to those remarks except to say that stopping tuition increases now is not enough.

Tuition has been going up so rapidly for so long it has reached nearly ungraspable levels. So let me put today's tuition cost in concrete terms. Senators, what would your constituents say if gasoline cost $9.15 a gallon? Or if the price of milk was over $15? That is how much those items would cost if their price had gone up at the same rate that tuition has since 1980.

I believe that skyrocketing tuition is undoubtedly the biggest "access" problem in higher education. What can possibly be more discouraging to a capable student whose parents are not wealthy than a school with a $45,000 price tag on the door?

Here's another concrete comparison. The total worth of the top 25 college and university endowments is $11 billion greater than the combined assets of the 25 largest private foundations — including the Gates Foundation, Ford, and Rockefeller.[viii]

Private foundations have fewer assets and, in part because they give away more of their money, are growing far less. Yet they are spending more—their payout averaged 7% in 2005 even though they are legally required to spend just 5%.[ix]

Yale law professor Henry Hansmann has said that "A stranger from Mars who looks at private universities would probably say they are institutions whose business is to manage large pools of investment assets and that they run educational institutions on the side...to act as buffers for the investment pools."[x]

Senators, our colleges and universities need to be reminded that they are education institutions first and foremost—and that that is why they receive the enormous tax breaks they do. Their practices, including their handling of endowment monies, should reflect their priorities as educators.

Payout information and other basic higher education endowment statistics must be brought out of hiding—made available, for example, via the Department of Education's website in addition to making permanent the proposed endowment-related revisions to IRS Form 990. Should this sunshine prove insufficient motivation, Congress should not hesitate to consider a minimum payout requirement—and 5% should be considered a starting point. The 5% number is a dated one—even for private foundations. Many schools have been rolling over so much money for so long that they should easily be able to accommodate a higher rate of payout. Possibly the most significant challenge for policymakers will be to make sure that any newly directed monies actually go toward aid or tuition reduction and don't become part of a shell game.

Again, thank you for inviting me to testify. I'll be happy to answer any questions.

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[i] National Association of College and University Business Officers, "2006 NACUBO Endowment Study," http://www.nacubo.org/documents/research/2006NES_Listing.pdf.
[ii] "2006 NACUBO Endowment Study," part four, p. 46, table 37.
[iii] "2006 NACUBO Endowment Study," part two, p. 17, table 13.
[iv] "2006 NACUBO Endowment Study," part one, p. 3, table 1.
[v] "1994 NACUBO Endowment Study," exhibit 8; "1987 NACUBO Endowment Study," p. 92, table 78.
[vi] "2006 NACUBO Endowment Study," part four, p, 40, table 31.
[vii] Council for Aid to Education, "2005 Voluntary Support of Education," p. 13, table 12.
[viii] Foundation Center, "Foundation Growth and Giving Estimates," 2007 edition, p. 7. http://foundationcenter.org/gainknowledge/research/pdf/fgge07.pdf
[ix] Foundation Center, analysis of table titled "Change in Foundation Statistics, 2004 to 2005," p. 4.
[x] Hansmann quoted in Peter Brimelow, "Professor Scrooge," Forbes (October 19, 1998), p. 60.

Questions for the Record
Offshore Tax Issues
September 26, 2007
Question for Ms. Munson

Question from Senator Roberts
I understand that a university endowment is usually comprised of thousands of donations that are often restricted for certain purposes. These restricted donations are important to funding scholarships, attracting and retaining top-flight professors, and promoting cutting-edge research. How would you structure a payout requirement that would respect the restrictions placed on a good portion of donations made to endowments? Would it be possible to create a payout requirement that would recognize the intent of the donor and ensure trustees do not breach their duties to their endowment?

Answer from Lynne Munson
Many of the associations that are fighting any mandatory annual endowment spending requirement argue that it would interfere with institutions' ability to abide by the restrictions donors put on their gifts. But colleges and universities themselves have provided information that proves this claim to be false. And research suggests that a spending requirement might actually compel institutions to be more responsive to donor wishes than they are now.

Every year hundreds of endowed institutions of higher education participate in a voluntary survey conducted by the National Association of College and University Business Officers [NACUBO]. Because no agency of the federal government currently collects information on higher education endowments, this survey is the most definitive source of information about them. The most recent edition of the NACUBO survey included data from 765 institutions and was published in February 2007.

Private institutions reported that just 32% of their endowment funds are permanently restricted. And only 23% are restricted temporarily. Nearly half of endowment funds at private institutions (44.6% to be precise) are entirely <u>un</u>restricted. A larger proportion of endowment funds are restricted at public institutions, yet still not enough to interfere with any reasonable spending requirement. The NACUBO survey made no distinction between permanent and temporary restrictions at public institutions. Participating public institutions reported that 20% of their endowment funds are <u>un</u>restricted. The percentage of unrestricted funds rose to 25% for public institutions with endowments greater than $1 billion.

Keeping in mind also that higher education endowments have enjoyed double-digit gains for more than a decade, there clearly is no threat that a reasonable spending requirement—even one as high as 8%--will interfere or conflict with donor restrictions. In fact an annual payout requirement might better assure that schools are respecting donor intent by compelling institutions to stop hoarding endowment funds and instead spend gifts as donors wish. Let me illustrate this point by looking a bit more closely both at the proportion of donations restricted for financial aid and at actual institutional spending in that area.

A donor who restricts their gift is more likely to earmark it for financial aid than for any other purpose. According to the Council for Aid to Education's 2005 Voluntary Support of Education report, donors earmarked 36% of restricted donations for aid, vastly outpacing any other area including academic divisions (19%), faculty and staff compensation (18%), research (6%), and athletics (2%). If the percentage of donations earmarked for aid is added to the percentage of unrestricted funds the result is a total pool of 64% of endowment funds available for financial aid use at private institutions. Similarly, 48.5% of endowment funds could be used for financial aid at public institutions. Yet in some cases including the University of Michigan, Stanford, and elsewhere schools are spending less than 1% of the value of their endowment on aid. Almost none of the most heavily endowed schools (which now total more than 125) are spending a truly significant sum on aid, a fact made clear by looking at college and university financial aid outlays as a percentage of their endowment.

This begs numerous questions, including: With so many donors asking for their gifts to be used for aid, why are schools spending so little on it? After all, if a donor gives a gift to an institution and asks that it be spent on financial aid are his wishes really being honored if his gift remains unspent for generations?

Senator Pat Roberts
Statement for the Record
Offshore Tax Issues: Reinsurance and Hedge Funds
Senate Finance Committee
September 26, 2007

Mr. Chairman:

In recent years, university endowments have seen strong earnings on investments. Like other tax-exempt organizations, such as pension funds, endowments are increasingly directing their investments into alternative funds, many of which are based outside the United States. This investment strategy has delivered annual returns in the 15-20 percent range for many endowments and have led some to question whether as tax-exempt organizations, endowments should be making pay-outs that may be more aligned to their earnings and growth.

Today's witnesses will testify that Congress should consider, in light of their tax-exempt status and their strong returns on investment, whether university endowments are providing sufficient support to their universities and students. And, they will suggest that Congress look at a mandatory pay out requirement for university endowments, similar to the requirement for private foundations.

University endowments provide funding to support every aspect of the institution. These investments help to support and sustain the university, by providing funds for academic research, attracting top flight professors, offering student aid programs and maintaining and improving infrastructure and facilities. Often, however, endowments are comprised of thousands of individual donations, many of those restricted for specific purposes. We need to understand if it would be possible to create a pay out requirement that would recognize the intent of the donor and ensure trustees do not breach their duties to their endowment.

I agree that we should take a hard look at the benefits endowments are providing to their universities. I am disappointed that we do not have a representative of university endowments present today to provide an alternative perspective to the witnesses suggestion that Congress should require endowments to payout a specific amount to university programs. University endowments span a wide economic spectrum, with the largest being over $25 billion. Before Congress mandates an across-the-board payout rate, we must educate ourselves on the resulting impact to schools with smaller, less competitive endowments.

STATEMENT OF

DANIEL S. SHAPIRO

ON BEHALF OF

THE MANAGED FUNDS ASSOCIATION

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

SEPTEMBER 26, 2007

Chairman Baucus, Ranking Member Grassley and Members of the Committee, my name is Daniel S. Shapiro. I am a founding partner of the New York City law firm of Schulte Roth & Zabel LLP and am resident in the firm's London office. I have provided tax advice to private investment funds for over 30 years. I appear today on behalf of the Managed Funds Association, commonly known as MFA. MFA welcomes this opportunity to participate in the Committee's hearings on the manner in which private investment funds, their managers and their investors are taxed. In accordance with the Committee's request, this statement will focus principally on how hedge funds are structured and, in particular, on matters related to hedge funds established outside the United States by U.S.-based hedge fund managers.

MFA is the voice of the global alternative investment industry. Its members include professionals in hedge funds, funds of funds and managed futures funds. Established in 1991, MFA is the primary source of information for policymakers and the media and the leading advocate for sound business practices and industry growth. MFA members represent the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the over $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

I

Introduction and Summary of Testimony

Hedge funds sponsored by U.S.-based managers play an important role in the U.S. capital markets and make positive contributions to the U.S. economy as a whole. These managers must, however, compete globally for talented personnel, for investment opportunities and for investors. Their ability to do so effectively is influenced by many factors, including the U.S. tax system.

Hedge funds are structured in accordance with well established principles of tax law, as set forth in the Internal Revenue Code, Treasury regulations, rulings by the Internal Revenue Service and other applicable legal authorities and this structure also promotes key Congressional tax and economic policies. This is true in the case of funds that U.S.-based hedge fund managers establish outside the United States in order to compete with non-U.S. managers for passive investors from Europe, Asia and elsewhere.

For more than 40 years, Congress has structured the tax code to encourage passive foreign investments in the U.S., both by foreign corporations and individuals. Among other things, Congress has exempted most forms of interest payments made to these passive investors from U.S. withholding tax and it has likewise exempted their capital gains from U.S. tax except to the extent they are derived from sales of U.S. real estate and certain U.S. real estate securities. Despite this advantageous treatment, most foreign investors utilize foreign corporations as the vehicle for their passive investments into the United States and U.S.-hedge fund managers would be competitively disadvantaged if they did not offer such a structure to foreign investors.

The foreign funds organized by U.S.-based hedge fund managers to attract foreign passive investors are corporations and they are subject to this same tax regime so long as they limit themselves to passive investment activities, including trading and investing in stocks, securities and commodities. These funds thus do not provide the ultimate foreign investors with more advantageous tax treatment on their U.S. investment income than they would receive if they invested directly. The foreign funds established by U.S.-based hedge fund managers simply promote the Congressional policy to encourage passive foreign investment in the United States and at the same time enable U.S.-based managers to compete for those investors.

Pension funds, university endowments and certain other U.S. tax-exempt organizations also invest in foreign hedge funds sponsored by the U.S.-based managers. These organizations invest in hedge funds to maximize the investment returns they need to carry out their public interest missions. They structure their investments in this manner because, under a quite technical tax law provision, their investment returns would be reduced by the 35 percent unrelated business income tax if they invested in a U.S. hedge fund, organized as a partnership, that used leverage to enhance its returns. In such a case, the position of the tax-exempt investor vis-à-vis the fund is no different than if it had purchased the stock of a publicly traded company on the open market.

The use of foreign corporate funds by U.S.-tax exempt organizations does not trigger this adverse tax result and its use has been sanctioned by Internal Revenue Service rulings as well as implicitly by Congress in 1996. Moreover, from a tax policy standpoint, there appears to be little basis for imposing the unrelated business income tax on passive investment income received by a pension fund or other tax-exempt organization where it has no liability for the leverage used by the fund, has no control over the fund's investments or the extent of its use of leverage, and does not incur any indebtedness to acquire or carry its investment in the fund.

In this connection, MFA welcomes the introduction of H.R. 3501, which appears intended to eliminate the need for U.S. tax-exempt organizations to structure their hedge fund investments as investments in foreign funds. As discussed elsewhere in this statement, MFA believes that H.R. 3501 needs to be amended in certain respects in order to achieve its intended objectives.

Some U.S.-based managers elect to defer receipt of a portion of the payments they receive from the offshore funds they sponsor. Foreign investors frequently expect these deferral elections to be made as the resulting deferrals buttress the alignment of interests between the manager and the investors. These deferrals are taxed in the U.S. at the top income tax rate of 35 percent when they are received by the managers at the end of the deferral period and they are subject to the comprehensive tax regulatory regime enacted by Congress in 2004 to govern deferred compensation arrangements by all business enterprises. These deferral arrangements also facilitate the ability of U.S.-based managers to establish deferred compensation plans for their employees and this in turn enables these managers to compete for and retain talented personnel.

MFA is well aware that this Committee is also considering other tax policy proposals relating to hedge funds that are outside the requested scope of this statement. These proposals include the treatment of so-called "carried interests" and the application of the publicly-traded partnerships rules to public offerings of interests in hedge fund and private equity fund managers. These proposals are not unique to hedge funds. For example, many types of private investment funds provide carried interests. Moreover, many hedge fund managers already pay income tax at the top 35 percent rate on substantial portions of their carried interest income. As discussed below, MFA has significant reservations regarding these proposals and would welcome the opportunity to present its views on these issues to the Committee in greater detail as the legislative process moves forward.

II

Hedge Funds and Their Importance to the American Capital Markets

MFA welcomes the interest of the Committee in the hedge fund industry and is pleased to participate in the process by which the Committee will examine issues related to the manner in which these funds, their managers and investors are taxed. MFA believes that these issues are best addressed following an examination of the key characteristics that distinguish hedge funds from other private investment funds and of the important role hedge funds play in the American economy.

A. What is a "Hedge Fund"?

Hedge funds are part of what is commonly referred to as the alternative investment sector of the capital markets. This sector also includes private equity funds, venture capital funds, real estate funds, mezzanine debt funds, and structured debt funds, among others. In 1999, the President's Working Group on Financial Markets defined a hedge fund as "a private investment pool that is professionally managed, not available to the general public and typically limited to high net worth individuals and institutional investors".

Other private investment pools share some of these same characteristics and, in MFA's view, hedge funds have five key characteristics, as follows:

> First, hedge funds pursue absolute returns, which are not correlated with stock market returns, and do so within defined risk parameters.
>
> Second, there is no single investment strategy that is common to all hedge funds.
>
> Third, there generally are no public offerings of interests in hedge funds, a fact which, in order to ensure compliance with the federal securities laws, results in substantial limitations on the ability of hedge funds and their managers to communicate with the public through public announcements of fund-specific investment results, advertisements, press interviews and open websites.
>
> Fourth, to comply with applicable securities laws, hedge funds generally are directly available only to high net worth individuals and institutional investors.
>
> Fifth, hedge fund managers profit principally by sharing in the returns earned by the funds themselves, and often make significant investments in the funds they manage, thus directly aligning the interests of the fund's manager with the interests of the investors in the fund.

B. Hedge Funds and the Capital Markets

As the President's Working Group on Financial Markets and its constituent members, including the Department of the Treasury, have repeatedly stated, hedge funds provide important benefits to the U.S. capital markets and to the American economy as a whole. For example, hedge funds are an important source of liquidity, not only in the traditional markets for equity securities, but in other markets such as those for distressed debt, convertible debt, and asset-backed securities. As former Treasury Under Secretary Quarles stated in testimony presented to the Senate Banking Committee on May 16, 2006, U.S. markets are attractive to investors, both domestic and foreign, because they are among the deepest and most liquid in the world and "hedge funds are significant liquidity providers in many marketplaces".

In addition to providing liquidity in the form of risk capital, hedge funds promote price efficiency in the capital markets, contribute to capital formation in many sectors of the economy, and frequently identify new and emerging markets. Moreover, by being active participants in off-exchange derivatives transactions, such as currency and interest rate swaps, hedge funds contribute to the deep and liquid marketplace in such instruments that enables "Main Street" American businesses, as well as banks and others, to manage many of the risks inherent in their core businesses in an efficient and cost effective manner.

Hedge funds and other private investment funds also help keep the U.S. capital markets competitive. As Treasury Under Secretary Steel stated on February 27, 2007:

> United States capital markets are the envy of the world. Our markets are deep, efficient and transparent. Creativity, innovation and entrepreneurship have long been the hallmark of U.S. markets and their benefits to our economy are clear. Private pools of capital—which include venture capital, private equity, and hedge funds—have helped make us the world's leading financial innovator. As Secretary Paulson noted in a speech last November, private pools of capital are an essential part of what keeps our capital markets the most competitive in the world."

C. Hedge Fund Investors

As noted, hedge fund investments are directly available generally only to high net worth individuals and institutional investors. These institutional investors include pension funds, university endowments and other similar institutions. Hedge funds provide these investors with the opportunity to enhance significantly their ability to carry out their missions by diversifying their portfolios, earning stable returns and protecting their capital during periods of downward price movements in the public securities markets. The investment performance hedge funds have provided to tax-exempt investors arises from the fact that hedge fund managers seek returns that are not correlated to the markets (as opposed to merely seeking to magnify market returns). Thus, while hedge funds' performance occasionally may not exceed mutual funds' performance in rising markets, they have in past years consistently provided positive and stable returns when the general markets are experiencing downturns. Thus, in the case of pension funds, for example, hedge fund investments can, in the context of a balanced and professionally managed portfolio, provide greater retirement security for millions of Americans in all walks of life, including teachers, law enforcement and fire officials, and municipal workers.

III

Technical Explanation of Hedge Fund Structures

As noted at the outset of this statement, hedge funds are structured in accordance with long established tax rules, as set forth in the Internal Revenue Code, Treasury regulations, Internal Revenue Service rulings, and other applicable authorities. As also noted, the typical hedge fund structure also promotes key Congressional tax policies, including those intended to encourage inbound investment into the United States.

A. Overview

A "hedge fund" with a U.S.-based manager typically consists of both a U.S.-based fund and a foreign fund, each of which has the same investment objectives. The U.S. fund is generally organized as a limited partnership and there is thus a single level of U.S. federal income tax on the fund's investment income, which is imposed at the partner level. This structure has been used, virtually without exception, by hedge funds and other private investment funds for decades. The principal investors in the U.S. fund are U.S.-based investors that are subject to the U.S. federal, state and local tax in their own right. The foreign fund is generally organized as a corporation (or as an entity that is eligible to elect to be classified as a "corporation" for U.S. tax purposes) and it is used as the vehicle for investment by those investors whose passive investment activities in the U.S. have, as discussed below, largely been exempted from tax by Congress and the foreign fund's structure simply facilitates that result.

In some cases, the U.S. fund and the foreign fund make parallel investments and in other cases (commonly referred to as "master-feeder" structures) the U.S. fund and the foreign fund (the "feeders") invest in a third fund (the "master fund") which makes the actual investments. In this structure, the master fund is typically organized as a partnership (or as an entity eligible to be taxed as a "partnership" for U.S. tax purposes).

B. U.S. Taxation of Foreign Investment

The provisions of the Internal Revenue Code governing foreign investment in the United States embody certain fundamental principles that, taken as a whole, reflect a clear Congressional intent to encourage non-U.S. persons to invest in the U.S. economy.

Current tax law distinguishes between those non-resident aliens and foreign corporations that are not engaged in a trade or business in the United States ("passive foreign investors") and those that are so engaged. In general, passive foreign investors are subject to U.S. tax only on their U.S. source dividends, certain interest, rents and royalties (collectively, "fixed or determinable, annual or periodical" gains, profits and income). This tax is generally collected via withholding at a flat 30 percent rate. Significantly, many types of interest payments made by U.S. payors, including the United States government, to passive foreign investors are not subject to U.S. withholding tax at all (e.g., under the so-called "portfolio interest" exemption). Finally, passive foreign investors are not subject to tax on their U.S. capital gains except in the case of gains from certain investments in U.S. real property and U.S. real property interests.

In contrast, non-resident aliens and foreign corporations that are engaged in a trade or business in the United States, and are thus not merely passive investors in the U.S. economy, are subject to U.S. tax on a net income basis, generally at a 35 percent rate. This tax generally is imposed with respect to all income, both U.S. source and foreign source, that is "effectively connected" with the U.S. trade or business. In addition, in such cases, a so-called "branch profits tax" is imposed on the repatriation of such "effectively connected income" and this may result in a combined effective tax rate that is substantially in excess of 50 percent.

As a result of these differences in the way foreign investors are taxed, passive foreign investors remain vigilant to ensure that their activities do not inadvertently fall within those categories of activities that may be treated as a U.S. trade or business. To ensure the steady flow of foreign investment funds into the United States, Congress acted as long ago as the Foreign Investors Tax Act of 1966 to provide certainty to passive foreign investors whose activities within the U.S. capital markets consist principally of trading or investing in stock, securities and commodities. Specifically, Congress enacted statutory safe harbors providing that the proprietary trading of, and investing in, stocks, securities and commodities will not be treated as engaging in the conduct of a trade or business within the United States. As the Committee is well aware, for many years the proprietary trading safe harbor for stocks and securities was available to foreign corporations (including most foreign hedge funds) only if the foreign corporation maintained its "principal office" outside the United States. In 1997, Congress amended the law to eliminate this requirement in order to stimulate foreign funds and others to increase the number of employees and service providers based in the United States. Most if not all foreign hedge funds structure their activities to fall within these two proprietary trading safe harbors.

C. Taxation of Foreign Funds and Non U.S. Investors in Foreign Funds

As noted, foreign hedge funds sponsored by U.S.-based managers are generally organized as corporations or as entities that can elect, under Treasury regulations, to be taxed as corporations for U.S. tax purposes, and are located in a tax-neutral jurisdiction to avoid double taxation of the foreign investors. The corporate structure is used to enable the foreign fund to attract investors from the U.K., Europe, Asia and elsewhere. These investors insist upon such a structure principally to ensure that their other assets (i.e., the assets they do not invest in the fund) will not be subjected to U.S. tax should the foreign fund inadvertently engage in activities that are found to constitute the conduct of a trade or business within the United States. Absent such a structure, U.S.-based fund managers would not be able to compete with fund managers based in the U.K., Europe, Asia and elsewhere for non-U.S. investors who wish to invest in the U.S. on a passive basis.

This structure does not create new U.S. income tax benefits for foreign passive investors that they could not obtain if they were direct investors in the United States because the foreign fund is subject to U.S. withholding taxes on the dividends, certain interest, rents and royalties it receives to the same extent as any other passive foreign investor. Moreover, while the foreign fund is exempt from U.S. tax on its capital gains (except those attributable to the disposition of U.S. real property interests), that exemption is available to all passive foreign investors. Despite this advantageous treatment of passive foreign investors, most foreign investors utilize foreign corporations as the vehicle for their passive investments in the United States and they would be unlikely to invest with U.S.-based hedge fund managers if those managers did not provide such a structure. In short, the use of a foreign fund enables U.S.-based managers to compete for passive foreign investors.

D. U.S. Tax-Exempt Investors in Offshore Funds

Pension funds, university endowments and most other U.S. tax-exempt organizations are generally exempt from U.S. tax on their passive investment income, but they are typically subject to the unrelated business income tax ("UBIT"). This tax is generally imposed at the regular corporate income tax rate of 35 percent.

UBIT was originally enacted in 1950 to prevent tax-exempt organizations from exploiting their tax exempt status by acquiring an unrelated operating business and enabling that business to compete unfairly with taxable enterprises. The UBIT base was thereafter expanded by Congress to include so-called "debt financed income". The legislative history of the debt-financed income amendment suggests that Congress was principally concerned with abuses of the original legislation through techniques such as leveraged acquisitions of operating business assets. Nevertheless, the statutory definition of "debt financed income" has a much broader reach and includes such items as dividends on stock of a publicly traded company if the stock was purchased through a margin account.

As the Committee is well aware, hedge funds frequently employ leverage as an integral part of their investment strategies to enhance returns to investors. The amount of leverage used by an individual manager of a hedge fund varies widely, depending on, among other things, the particular manager's investment strategy, view of the market and the current cost of borrowing. Under the current UBIT rules, if a tax-exempt organization invests in a U.S. hedge fund organized as a partnership, a portion of the fund's leverage would be imputed to the tax-exempt organization in its capacity as a limited partner (passive investor) in the fund. The imputed leverage would expose the tax-exempt organization to liability for UBIT on its investment returns from the fund even if, as is almost universally the case, the tax-exempt organization had no liability for the fund's debts, had no control over the fund's investments and did not incur any indebtedness to acquire or carry its investment in the fund.

As a result of the application of UBIT to investments in U.S. hedge funds that use leverage, tax-exempt organizations have for some years made their hedge fund investments through the foreign fund (a corporation, for the reasons discussed above). Under current law, none of the leverage used by the foreign fund is imputed to the tax-exempt shareholder (passive investor). Thus, gains realized by the tax-exempt shareholder on a complete or partial redemption of its interest in the foreign fund are not subject to UBIT.

Both Congress and the Internal Revenue Service have sanctioned the use of these structures by tax-exempt organizations for investments in foreign funds. Specifically, while the passive foreign investment company ("PFIC") rules enacted in 1986 apply onerous tax rules to most U.S. taxpayers investing in a foreign hedge fund, the implementing regulations exempt, in accordance with Congressional intent, U.S. tax-exempt organizations from the PFIC rules. In 1996, Congress considered proposals to apply a "look through" rule under which dividend income received by a U.S. tax-exempt organization from a controlled foreign corporation would be subject to UBIT to the same extent the underlying income would be taxed under UBIT if earned directly by the tax-exempt organization. Congress flatly rejected such an approach except in those limited cases where the foreign corporation was actively engaged in an insurance business and thus presented the potential for the very type of unfair competition at which the original UBIT provisions were aimed.

Moreover, in its general explanation of the 1996 legislation, the staff of the Joint Committee on Taxation stated that Congress believed that the prior IRS rulings declining to impose such a look through rule were correct and, since the 1996 legislation, the IRS has issued an additional series of "no look through" rulings, including rulings to U.S. tax-exempt organizations with respect to investments in foreign funds.

Current practice is not merely a technically correct application of the current tax code. It is also consistent with the underlying purposes of UBIT. When a tax-exempt organization invests in a foreign hedge fund, it does not incur any debt to finance the investment (or else UBIT would apply to that extent), it has no liability for any of the debt incurred by the fund, and it has no control over either the investments made by the fund or the extent of leverage employed by the fund in doing so. In short, the tax-exempt organization receives only passive investment income and its position vis-à-vis the foreign fund is no different than if it had purchased shares of corporate stock (and many corporations use often substantial leverage in connection with their business operations).

As the Committee is aware, many tax-exempt organizations, especially universities across the country, have been able to achieve significant growth in their endowment funds by investing in a wide variety of hedge funds. A significant percentage of those investments have been made, either directly or through funds of funds in foreign hedge funds, many of which use substantial leverage. If the universities, and other tax-exempt organizations such as pension funds that have also been increasing their allocations to hedge funds, were to be made subject to UBIT on those investments merely because the managers of the foreign funds decided to seek enhanced returns through leverage, their rates of return would be very materially diminished. The potential for such marked adverse effects of a change in the current tax rules should therefore be given the most careful consideration.

In light of the foregoing, MFA welcomes the introduction of H.R. 3501. This legislation would amend the UBIT provisions of the Internal Revenue Code relating to debt-financed income and appears intended to eliminate the need for U.S. tax-exempt organizations to structure their hedge fund investments as investments in the foreign funds sponsored by U.S. managers. H.R. 3501, would accomplish this objective by creating a statutory safe harbor under which indebtedness of a U.S. fund would not be attributed tax-exempt investors in the fund if certain requirements are satisfied.

MFA believes that, if H.R. 3501 is to achieve its apparent objective, it needs to be amended in certain respects. Let me illustrate. First, the safe harbor would apply only if the U.S. fund is organized as a limited partnership. In fact, some funds are organized differently (e.g., as limited liability companies). Second, the safe harbor would apply only to indebtedness incurred by the fund with respect to qualified securities and commodities. In fact, while most hedge funds invest principally in securities and commodities, many funds make other leveraged investments some of which may not fall within this definition. Third, the safe harbor would incorporate the so-called "fractions rule", which was enacted in committee legislation to permit pension funds and certain educational institutions to participate in leveraged real estate partnerships. This rule, which is quite complex to apply, was enacted to restrict shifting of tax benefits (such as depreciation) when a tax-exempt entity invests in a real estate partnership. This potential does not, in MFA's view, exist to any significant degree in the case of hedge funds. MFA therefore believes that, in lieu of expanding the reach of the fractions rule, it may be more desirable for the Congress to consider granting the Treasury and the Internal Revenue Service regulatory authority to address arrangements that inappropriately shift tax benefits from tax-exempt to taxable investors in the fund. MFA would be pleased to work with the Committee on these and related technical issues.

E. Payments to U.S. Managers

Hedge fund managers frequently receive both fixed payments (based on a percentage of the value of assets under management) and incentive payments (based on investment performance) from the foreign funds they sponsor. These payments are subject to U.S. tax as ordinary income when received. In some instances, the manager may elect to defer the payment of a portion of these amounts to a subsequent taxable year. In those cases, the deferrals, together with any actual or notional earnings thereon, are subject to U.S. tax as ordinary income when received at the end of the relevant deferral period and are taxed at the top 35 percent tax rate.

Foreign investors frequently expect the election of such deferrals to be made by the manager since the deferrals buttress the continuing alignment of interests between the manager and the investors. As noted above, the onerous PFIC rules make it very burdensome for the manager to invest directly in a foreign fund, as they frequently do in U.S. funds.

Moreover, the deferred amounts remain as general assets of the foreign fund and are subject to risk of loss in the event of future adverse investment performance or if the foreign fund becomes insolvent and is unable to meet the claims of creditors. Thus, as to its elective deferrals, the manager is simply a general unsecured creditor of the fund. In this sense, these deferrals differ from tax-qualified arrangements such as traditional pension plans and section 401(k) plans. Those plans are funded and the amounts set aside in the trusts or other funding vehicles can be used only to pay benefits and are not subject to claims of the employer's creditors.

These elective deferrals by fund managers generally are subject to the rigorous regulatory regime for nonqualified deferred compensation arrangements enacted by Congress in 2004, as are any deferred compensation plans maintained by the manager for its employees and other service providers. Some hedge fund managers use plans in this latter category to attract and retain key personnel through deferred compensation arrangements that are linked to the manager's elective deferrals with the foreign funds it sponsors. Careful thought should be given to these issues prior to the enactment of tax policy changes that would limit their ability to do so.

As set forth in section 409A of the Internal Revenue Code, the 2004 legislation imposes strict rules governing deferral elections, the circumstances under which deferred amounts can be paid, and the limited conditions under which payment of deferred amounts can be accelerated. Final regulations under section 409A were issued by the Department of the Treasury and the Internal Revenue Service earlier this year. Those regulations confirm that section 409A does in fact generally apply to deferral arrangements involving hedge fund managers and that, accordingly, plans involving hedge fund managers are subject to the same rules that apply to all other taxpayers. MFA has cooperated fully with the Treasury and the Internal Revenue Service to ensure the proper and timely implementation of section 409A and it will continue to do so.

IV

Concluding Observations

MFA is well aware that the tax treatment of foreign funds is but one of a series of tax policy proposals concerning hedge funds and other alternative investment funds that are under active consideration by this Committee and others. These include H.R. 2834, which would alter the tax treatment of income attributable to so-called carried interests and S. 1624, which would limit the ability of investment advisory firms to engage in public offerings of equity interests while maintaining their "partnership" tax status. These and other similar proposals would reverse long standing tax policies related to partnerships and could have potentially significant and disparate effects on the way in which capital is raised and deployed in major segments of the economy, with consequent effects on economic development and job creation. MFA believes that Congress should carefully consider the potential macroeconomic effects in deciding whether to enact such tax law changes.

Similarly, MFA believes that Congress should carefully consider the impact of the pending proposals on the continuing erosion of the traditional position of the United States as the world's leading financial center and source of financial innovation. This process is already underway as other countries seek to exploit their natural advantages, including location, and the capital markets continue to be increasingly global in nature. U.S.-based hedge fund managers are important to the competitive position of the U.S. in the financial services sector. These managers compete globally for investors, key personnel and investment opportunities. Tax legislation that compromises their ability to compete effectively in any of these areas could have adverse effects on the competitive position of the U.S. as a global financial center.

As noted above, these proposals are not unique to hedge funds. For example, many types of private investment funds provide carried interests. Moreover, many hedge fund managers already pay income tax at the top 35 percent rate on substantial portions of the income attributable to carried interests in the U.S. funds they sponsor as a large percentage of such income is attributable to trading profits from stocks and securities held for less than a year. H.R. 2834 does not, however, merely raise the rate of tax on income from carried interests. It also recharacterizes such income as compensation for services. As other testimony presented to this Committee in connection with this hearing suggests, such recharacterization of what would otherwise be short or long term capital gains in this context appears to be largely unprecedented. Moreover, it could have significant adverse collateral effects under other provisions of the Internal Revenue Code and under state and local tax laws.

MFA also has significant policy concerns with S. 1624, which would limit the ability of investment fund management companies from engaging in public offerings unless they forfeited their "partnership" tax status. MFA questions whether there is a compelling tax policy rationale for S. 1624. For example, the assets of these companies have almost always been held by partnerships and MFA thus doubts that public offerings by such companies should be characterized as increasing the potential for erosion of the corporate tax base. Moreover, MFA questions whether investment managers should be subject to a different tax regime than publicly traded partnerships organized in other sectors, such as oil and gas, commodities, substitute fuels, etc. MFA also believes that Congress should give careful consideration to the fact that fund managers that have engaged, or in the future may do so, in public offerings are important participants in the U.S. capital markets and that public offerings by such firms will both increase transparency due to the disclosure requirements of the federal securities laws and facilitate succession arrangements designed to enhance the stability of these firms.

MFA would welcome the opportunity to present its views on H.R. 2834, S. 1624 and similar proposals to the Committee in greater detail.

* * *

MFA appreciates this opportunity to present its views to the Committee on hedge fund structures and will continue to work with the Committee and others concerned as the legislative process moves forward.

Questions for the Record
Offshore Tax Issues
Senate Finance Committee
September 26, 2007

Responses of Daniel Shapiro

Questions from Chairman Baucus

1. Many hedge funds conduct their funds offshore in a master feeder structure. Generally, foreign and nonprofit investors invest in the hedge fund through a corporation incorporated in a low tax jurisdiction, such as the Cayman Islands. The hedge fund managers receive fees instead of carried interest. Economically, how is that different from a profits interest?

Most foreign hedge funds are organized as corporations or as entities that are eligible to elect to be treated as corporations for U.S. federal income tax purposes. The relationship between such a fund and its U.S.-based investment adviser is typically embodied in an investment management agreement (an "IMA"). Pursuant to the IMA, the adviser generally receives both a management fee and an incentive fee. The management fee is expressed as a percentage of the value of the assets of the fund and the incentive fee is based on the investment performance of the fund itself.

In contrast, most U.S. hedge funds are organized as partnerships or as entities that are eligible to elect to be treated as partnerships for U.S. federal income tax purposes. The U.S. investment adviser (or an affiliate of the adviser) typically serves as the general partner of the fund and has a so-called carried interest in the fund. The percentage interest represented by the carried interest is typically the same as the percentage of the incentive fee to which the adviser is entitled under its IMA with the foreign fund.

Despite the apparent similarity of the incentive fee and the carried interest and the fact that arrangement selected can be a matter of choice, the two arrangements have different economic and legal consequences as well as different tax consequences under current law. In the case of the foreign fund, the adviser's relationship is contractual in nature and typically can be terminated under prescribed circumstances. In contrast, the holder of a carried interest is a partner (a co-venturer for profit) and generally can be expelled only by actions taken by the other partners. Moreover, the adviser typically does not make a direct investment in the foreign fund (although it may elect to defer fees that are retained by the fund during the deferred period) and it has no exposure to the fund's creditors (other than loss of deferred fees in the event of insolvency of the fund). In contrast, the general partner of the U.S. fund typically makes a cash investment (e.g., one percent of the fund's capital) in the fund and may well have exposure to the fund's creditors.

In terms of tax consequences, the holder of a carried interest receives an allocation of partnership income (whose character is determined at the partnership level) and must adhere to the method of accounting used by the fund. In contrast, the incentive fee received by the adviser from the foreign fund is taxed as ordinary income when received (and its character as ordinary income is determined independently of the character of the income earned by the fund).

2. Some hedge fund managers elect to defer recognition of income from fees paid by an offshore corporation. Are these deferred fees in fact maintained offshore? Or are they maintained in hedge funds and bank accounts in the United States? Please provide examples from MFA members.

Fee deferrals by a U.S. adviser from a foreign fund are made pursuant to nonqualified deferred compensation arrangements and these arrangements are now generally subject to the comprehensive rules set forth in section 409A of the Internal Revenue Code. These deferral plans, including those in effect before the enactment of section 409A, must be "unfunded". As a result, an adviser that has deferred a portion of its fees has no rights in any specific asset of the fund and instead has only an unsecured contractual claim against the fund. While the fund will often maintain a bookkeeping account to reflect the deferrals and earnings thereon, these accounts do not involve any set asides of assets of the fund and the adviser does not, by reason of the establishment of such accounts, acquire any right, title, or interest in any specific assets of the fund and all benefits payable under the arrangement are made from the general assets of the fund. Thus, the adviser is at risk with respect to its deferrals in the event of the insolvency of the fund. Finally, it should be noted that section 409A effectively prohibits the setting aside of assets outside the U.S. to pay deferrals, either through a trust or other arrangement designated by the Internal Revenue Service.

While MFA does not have survey data on this issue, in many cases the deferrals are indexed to the performance of the fund and, in those cases, they are invested in the same manner as all other assets of the fund. Since many foreign funds with U.S.-based advisers do invest in the U.S. (e.g., in securities and commodities), the portion of their assets represented by those investments may often be in the U.S. in brokerage or bank accounts and I believe this industry norm would be consistent with the experiences of the MFA membership.

3. Please explain how a hedge fund manager may elect to defer income recognition of fees.

As discussed in connection with the preceding question, nonqualified deferred compensation arrangements between a U.S. adviser and a foreign fund are generally subject to the requirements of section 409A of the Internal Revenue Code, which was enacted in 2004 and is applicable to all income that was not both deferred and vested on or before 2004.

Section 409A provides comprehensive rules governing how deferral elections may be made. In general, it requires that an irrevocable election to defer by made by the U.S. adviser on or before the last day of the adviser's taxable year that immediately precedes the taxable year of the adviser in which the relevant services are performed. Thus, if an adviser is a calendar year taxpayer and wishes to defer a portion of its incentive compensation payable with respect to the fund's performance for calendar year 2008, the adviser must make an irrevocable deferral election on or before December 31, 2007.

Most if not all deferrals by U.S. advisers are made in accordance with a written plan (often called a "deferred fee agreement"), which sets forth the requirements for deferral elections, payment of prior deferrals and other relevant points, including those necessary to ensure compliance with U.S. tax laws (e.g., provisions that the plan is unfunded, as discussed in connection with the preceding question). Actual deferral elections are typically made annually in the form of a written election setting forth the amount to be deferred, the time and form of payment of the amounts so deferred, and other relevant matters.

Question from Senator Hatch

Mr. Shapiro, in your testimony you urge Congress to carefully consider the impact of the pending proposals on carried interest and publicly-traded partnerships on the continuing erosion of the traditional position of the U.S. as the world's leading financial center and source of financial innovation. Can you elaborate on this for me? Do you think these proposals would further damage the U.S. position?

The current challenge to the traditional position of the U.S. as the world's leading financial center and source of financial innovation is the result of a variety of factors,. These include the explosion of information technology (which has eliminated markets as a place to which one must physically "go" to transact business), the natural advantages that some locations possess (such as time zones), the emergence of new and vibrant market-based economies, and the growth of the capital markets into a global business.

As a result of these and similar factors, national and local governmental bodies throughout the world have become increasingly conscious of the contributions capital market participants (including investment fund managers) make to their economies and they now seek to become, or remain, financial centers through a variety of means, including regulatory and tax initiatives.

For these reasons, MFA believes that Congress should consider the potential impact that regulatory and tax proposals have on the overall competitive position of the U.S. in the global capital markets. While it is fair to say that it is the rare case in which a single tax matter will prompt businesses to favor one jurisdiction over another, taxes are nevertheless an important component of a nation's overall business climate. To illustrate, the Secretary of the Treasury and others, including Members of Congress, have devoted increasing attention to the question whether U.S. corporate income tax rates have become significantly out of step with worldwide rates and, if so, whether that disparity will have adverse effects on the U.S. economy.

In terms of the carried interest and publicly traded partnership tax proposals, MFA has expressed concerns that these proposals have yet to be fully vetted in terms of their impact on the competitive position of the U.S. For example, as the Treasury has testified, carried interests are widely used throughout the American economy to bring entrepreneurs and investors together and MFA believes that the re-characterization of income attributable to carried interests as income from the performance of services could have significant impacts on the way in which capital is raised and deployed in major sectors of the American economy. In addition, MFA believes it is useful to examine the way in which other countries have addressed similar issues, including but not limited to the United Kingdom (where recent legislative proposals would not distinguish between the tax treatment of "carry" income and other capital gains). The publicly traded partnership proposal likewise raises issues that merit debate, including questions as to whether the investment advisers to which the proposal is directed, and limited, should be discouraged from public offerings of equity securities that could both increase transparency and enable these large firms, which play significant roles in the American economy, to address issues of succession.

At the margin, enactment of these proposals could lead individual firms to take particular actions such as expanding their platforms in Europe or Asia rather than in the U.S. More importantly, however, Congress should in MFA's view consider these proposals in the larger context of the question whether the U.S. has established and will continue to pursue a regulatory and tax climate that is both stable and encourages firms to use the U.S. as a base for their global operations.

Question from Senator Roberts

In your testimony, you indicate MFA's support for H.R. 3501. You also mentioned that there are several suggestions you have to modify this legislation. Can you expand on those?

H.R. 3501 is intended to permit pension funds and other tax-exempt organizations to invest in a U.S. hedge fund without imposition of the tax on unrelated business income. Subsequent to the hearing, MFA provided to the Committee and others a memorandum containing three recommendations with respect to H.R. 3501. First, MFA recommended that the safe harbor provided by the bill not be limited to those U.S. investment funds that are organized as limited partnerships. Second, MFA suggested that the bill be amended to provide the Treasury with regulatory authority to expand the scope of the safe harbor to investments made by a U.S. fund that do not necessarily fall within the qualified security and commodity baskets designated in the original legislation. Third, MFA recommended that the so-called "fractions rule" (now applicable to certain real estate investment partnerships with tax-exempt investors) be deleted from the bill in favor of a grant of regulatory authority to prevent inappropriate tax benefit transfers. MFA believes that these changes will enable the bill better to accomplish its intended purpose.

COMMUNICATIONS

American Council on Education
Office of the President

October 10, 2007

United States Senate
Committee on Finance
203 Dirksen Senate Office Building
Washington, DC 20510-6200b

Re: Hearing on Offshore Tax Issues: Reinsurance and Hedge Funds, September 26, 2007

Dear Committee on Finance:

On behalf of the American Council on Education and the higher education associations listed below, I write to submit the attached statement for the record in the above-referenced hearing.

Thank you for your prompt attention to this matter.

Sincerely,

David Ward
President

DW/sh

On behalf of:

American Council on Education
Association of American Universities
National Association of Independent Colleges and Universities
National Association of State Universities and Land-Grant Colleges

One Dupont Circle NW, Suite 800, Washington, DC 20036-1193
Telephone: (202) 939-9310 • Fax: (202) 659-2212
Web: http://www.acenet.edu

Testimony for the Record
Submitted to the
United States Senate Committee on Finance
for the September 26, 2007
Hearing on Offshore Tax Issues: Reinsurance and Hedge Funds

On behalf of:

American Council on Education
One Dupont Circle, NW, Suite 800
Washington, DC 20036

Association of American Universities
1200 New York Avenue, NW, Suite 550
Washington, DC 20005

National Association of Independent Colleges and Universities
1025 Connecticut Avenue, NW, Suite 700
Washington, DC 20036

National Association of State Universities and Land-Grant Colleges
1307 New York Avenue, NW, Suite 400
Washington, DC 20005

October 10, 2007

Introduction

On behalf of the higher education associations listed above representing approximately 4,300 two- and four-year public and private colleges and universities, we are submitting this written testimony on college and university endowments for the September 26, 2007 hearing record. We appreciate the opportunity to submit this testimony to address testimony received by the Finance Committee which presented an incomplete and inaccurate picture of college and university endowments. In addition, we are responding to public policy proposals offered in witness testimony that would significantly harm the ability of colleges and universities to effectively manage their finances for the benefit of current and future students and faculty and the public good that higher education serves. While it is helpful that we are given the chance here to address the hearing testimony, it is unfortunate that the higher education community was not permitted the opportunity to present a live witness with experience and expertise managing endowments to the Finance Committee.

Endowments and Their Importance to Higher Education

Endowments are critical to sustaining high quality and excellence in American higher education. For over 350 years, endowments have supported the mission of colleges and universities by providing funding to: assist students; hire faculty; conduct research; construct facilities; and carry out other educational activities that would not have been possible if institutions had to rely solely on tuition, direct private philanthropy, or government funding.

Testimony by Jane Gravelle of the Congressional Research Service and Lynne Munson of the Center for College Affordability and Productivity created the mistaken impression that endowments function like simple savings accounts for colleges and universities that can be spent by an institution however and whenever it chooses. This is simply inaccurate. In fact, an endowment typically consists of hundreds - and in many cases, thousands - of individual funds provided by charitable gifts, as well as some institutional funds that are invested to support the institution's mission in perpetuity. An endowment provides donors the opportunity to transfer private dollars to public purposes with the assurance that their charitable gifts will serve these purposes for as long as the college or university exists.

A significant portion of an endowment is usually restricted by donors for specific educational or research purposes. A typical endowment gift includes legal restrictions regarding the use of the funds and the spending of revenue generated by the invested gift. At public institutions, an average of 80 percent of endowment assets were restricted in 2006, and at private institutions, an average of 55 percent of endowment assets were restricted. (See National Association of College and University Business Officers (NACUBO) 2006 Endowment Study). While some may mistakenly believe institutions "hide" or "hoard" money in restricted accounts to avoid spending it, colleges and universities actually prefer unrestricted donations which provide them with the greatest flexibility to use funds that best achieve their mission over time.

Donor restrictions are included in the legal documents that establish an endowment fund, creating binding terms for the manner in which the college or university may spend the donor's gift. For example, an institution is legally prohibited from spending funds on student financial aid from revenue generated from an endowment fund established by a donor to support cancer research or a professorship in a particular subject. In addition to donor imposed restrictions, there are also external restrictions that affect the payout of endowments. For example, the Uniform Management of Institutional Funds Act (UMIFA) has been recently amended and has already been adopted as modified by several states. UMIFA was modified to provide that if a payout from a fund exceeds seven percent, the fiduciary to the fund may be in violation of the Act's prudent management standards.

Moreover, of the approximately 4,300 U.S. nonprofit colleges and universities, most do not have endowments. Institutions that have most vibrant endowments are typically public or private research universities or private liberal arts colleges. For institutions with an endowment in 2006, the median endowment value was $79.8 million. (See 2006 NACUBO Endowment Study).

How Endowments Function

Endowment funds are typically created and managed to exist in perpetuity. A college or university manages its many individual endowment funds for the long-term by investing in a variety of financial instruments in order to control risk and provide for sustained returns that will support the educational and research missions of the institution. College and university endowments typically comprise some balance of the following type of investments: bonds, mutual funds, stocks, hedge funds, real estate, natural resources, and venture capital.

Institutional trustees charged with managing endowments are obligated to fulfill their broader fiduciary duties to their institution and seek to balance competing needs for the benefit of the institution. They must balance current spending needs and operations while seeking to provide for future needs. Most trustees and university endowment managers for the past few decades have strived to achieve what is known as "intergenerational equity," the principle that future students should be able to benefit from an endowment to the same degree that current students do.

Moreover, colleges and universities typically employ endowment spending or payout rules that seek to provide predictable and sustained funding for campus operations and the programs and activities for which donors restricted their gifts. Spending rules help to insulate institutions from the effects of market volatility on investment returns while also permitting sufficient reinvestment of revenue so that the endowment can retain its value relative to inflation. According to NACUBO, the most common spending rule adopted by institutions is to spend 5 percent of the three-year average of an endowment's market value. Such a spending rule is also know as a "smoothing" rule because it bases spending on a multi-year time frame that allows an institution to smooth out year to year market fluctuations affecting annual investment returns. College and university endowment spending rates have averaged between 4.5 and 5.1 percent of market value over the last decade. For the 765 institutions who participated in NACUBO's 2006 endowment study, the average spending rate was 4.6 percent.

The investments of college and university endowments must perform consistently well to meet current spending needs and achieve intergenerational equity for future generations. An annual investment return of approximately 9-10 percent is needed to: achieve the typical spending or payout rate goal of 5 percent; reinvest part of the investment earnings to maintain the endowment's value relative to inflation (2.5-3.5 percent); and pay for investment management costs (1-2 percent). In recent years, average investment returns have been strong. For 2005-2006, the overall average rate of investment return was 10.7 percent. Institutions with the smallest investment pools had an average rate of 7.8 percent and institutions with largest investment pools had an average rate of 15.2 percent. However, one only has to go back to 2000-2001 and 2001-2002 to find examples of when returns were not so rosy. In 2000-2001, the average return was -3.6 percent and in 2001-2002 the average return was -6.0 percent (See 2001 and 2002 NACUBO Endowment Studies).

Endowment spending is important, complex, and carefully managed. College and university trustees, leaders, and endowment managers take very seriously their legal and moral responsibilities to be good stewards of the charitable and other assets of their institutions. They seek to use endowment income to provide consistent and sustainable support for the educational and research missions of their institutions. Due to institutional endowment spending and smoothing rules, weak investment returns due to poor market conditions do not usually result in significant decreases in endowment spending. Moreover, increased endowment spending often trails behind increased investment returns so as to ensure benefits in the future that can be sustained. Taken together, these spending strategies provide stable funding and benefits over time and they often lead to real growth in the endowment that provides for additional benefits to students and society.

Endowment Uses and Benefits

Endowments enable colleges and universities to aim high and achieve their educational and charitable purposes more effectively. Endowments provide for a stable funding source, particularly during difficult economic times or in the event of natural or other catastrophes, and a degree of confidence about the future. Students and society are well-served by the fact that endowments allow institutions to deliver greater value and attain a higher level of quality in teaching and research that would not otherwise be possible from other sources of revenue such as tuition, government funding, or annual charitable gifts. They help institutions sustain quality and meet financial commitments to current and future students and faculty, as well as to society. Endowments also afford the valuable benefit of long-term planning to accommodate growth and improve academic and research programs. Additionally, in light of diminished commitments by government, endowments are a reliable source of funding to finance expensive construction and infrastructure needs.

Among the many academic programs, activities, and responsibilities of a modern higher education institution, the reliable source of funding that endowments provide permit colleges and universities to:

- provide or increase student financial aid;
- enhance undergraduate teaching;
- initiate pioneering research;
- renovate and maintain educational and research facilities;
- construct state of the art classrooms and scientific laboratories;
- invest in new information technologies;
- attract or retain talented faculty;
- increase public service activities of students and faculty; and
- offer new majors to reflect changing national or societal needs.

Of particular interest to many are the benefits endowments provide to make college affordable for students from low and moderate-income families. We are especially disturbed and concerned by the testimony of Ms. Munson and Ms. Gravelle at the September 26th hearing regarding university and college endowments and student financial aid. They painted an incomplete and disingenuous picture of colleges and university endowments and student aid.

The witnesses' testimony fails to examine the significant efforts of colleges and universities to provide increased institutional aid to students based upon need, and instead offers only broad generalities about endowment payout rates and increased tuition. Most – if not all – colleges and universities with the largest endowments are already providing a substantial amount of aid to students from low-income families. The average grant at most of these schools is above the cost of tuition and covers expenses including room and board, books, etc.

In the last five years alone, many of the universities and colleges with the largest endowments have created new or enhanced existing student financial aid programs to ensure that low- and even some middle-income students can access their institutions and graduate debt free. Qualified students are provided with a combination of federal, state, and institutional grants and in some cases work study opportunities in order to finance all of their tuition and living expenses. A free, top quality education is truly part of the American dream and institutions such as the following are making this possible each year for thousands of low-income students: the University of North Carolina at Chapel Hill; Emory University; the University of Washington; Stanford University; the University of Maryland at College Park; Princeton University; the University of Florida; Yale University; the University of Pennsylvania; Indiana University; Harvard University; Davidson College; Columbia University; Amherst College; and the University of Virginia. Harvard University, for example, covers all expenses for students from families making $60,000 or less.

In addition, many other institutions have, with endowment funding, created new or strengthened existing student financial aid programs to significantly increase institutional grants to offset tuition costs and reduce loan debt for both low and middle income students. Moreover, at a number of colleges and universities, endowment spending already contributes significant resources toward operating budgets, and in some cases, may be the largest source of revenue for the institution. In this way, endowment spending already serves to hold tuition rates below the level necessary if tuition alone paid the true cost of educating a student.

Proposals to Change Federal Tax Laws Affecting College and University Endowments

The public policy rationale for government support of colleges and universities is that higher education serves a public good, including educating citizens and conducting research that advances knowledge, spurs innovation, and contributes to our nation's economic prosperity. Colleges and universities clearly understand and appreciate the responsibilities that come with the significant support they receive from government as nonprofit entities that are exempt from most forms of taxation. College and university leaders and administrators take very seriously the educational, research, and public service missions of their institutions, and they strive to be responsible stewards of their institutions' endowments and finances.

The following addresses three proposals to federal tax law that would affect college and university endowments.

1. Rising Costs and Tuition – A Minimum Mandatory Endowment Spending Rate

The information and opinions offered by Ms. Gravelle and Ms. Munson at the September 26th hearing mischaracterized how college and university endowments function and their uses and benefits. Indeed, their descriptions were both incomplete and misleading. Both witnesses noted that tuition has been increasing faster than inflation. This is in fact the case, and increasing tuitions are a direct function of a combination of realities including: decreased state support for public institutions; increased federal, state, and regulatory requirements; increased health care and other employee benefits costs; increased energy costs; the demand and need for up-to-date information technology; and, student and family demands for increased services and amenities. However, their testimony also left the Committee with the impression that institutions are doing little to control costs or to increase student financial aid for individuals from low and moderate income backgrounds. This is simply not true.

Colleges and universities are implementing cost-saving measures continuously, and as previously described, institutions are creating new and enhancing existing student financial aid programs. It is part of their institutional mission and the fiduciary responsibility of trustees and administrators to make the institution accessible to qualified students. With respect to cost-saving measures, institutions are:

- replacing older high maintenance and high energy cost buildings with low-maintenance and low-energy consuming new facilities;
- using consolidated purchasing agreements;
- consolidating programs;
- outsourcing non-academic functions;
- providing incentives to employees to reduce costs;
- streamlining benefits administration;

- reorganizing administrative structures and reducing staff;
- increasing teaching requirements for faculty; and
- employing energy saving technologies.

These cost saving measures are only a sample of the ways institutions are attempting to reduce their costs so as to restrain tuition increases. Can colleges and universities do more to reduce costs? Yes, more can and should be done and institutions are actively and constantly looking to undertake cost saving measures that will work for their institutions. However, we should note that a significant share of the increasing costs of higher education cannot be controlled by universities. The persistent growth of federal, state, and local regulation is among the costs colleges and universities do not control but must deal with every year when crafting their budgets and determining tuition.

Ms. Gravelle and Ms. Munson both proposed the imposition of a mandatory minimum five-percent endowment spending rate to force colleges and universities to stop "hoarding" their resources and to spend more on student financial aid. On the surface, this proposal sounds like a reasonable and simple solution which institutions would have an apparently easy time implementing - it is modeled on the current law requirement for private charitable foundations to pay out a mandatory minimum of five-percent of the value of their endowments. However, it ignores the complexity of endowments, their restrictions, and the fiduciary responsibilities of institutions to preserve intergenerational equity.

Private foundations and colleges and universities are very different kinds of tax-exempt institutions. In the case of a private foundation, the public has an interest in ensuring that, in return for the tax advantages granted to the donor, the foundation, which remains under private control, is adequately serving its charitable purposes by spending its funds in a timely fashion. For foundations, virtually all of their income comes from their endowments and the most effective way to ensure a significant charitable activity may be through a minimum payout requirement. In contrast, charitable donations to college and university endowments are typically given for the express purpose of supporting designated educational or scholarly activities over a long period of time. When a college or university executes its daily operations, it fulfills and engages in its charitable purpose with endowment funds and other sources of revenue. There are many constituencies that play a role in ensuring that these dollars are spent for their intended purposes, including the donors themselves, students, faculty, university administrators, alumni, local residents, and government agencies.

Moreover, the work of private foundations and colleges and universities are fundamentally different. Private foundations make project-focused discrete grants, while colleges and universities fund academic and research programs into perpetuity. For example, a charitable health foundation may award an organization (perhaps even a university) a three-year grant to research the spread of a communicable disease; whereas, a university will use its endowment to fund ongoing and future health research programs and the researchers that conduct underpinning science.

As discussed previously, most larger colleges and universities typically target a 5 percent spending rate and, on average, they effectively achieve this on annual basis. Some institutions exceed this threshold and others fall short in a given year. A spending rate for a specific year that is below the institution's targeted spending rate is usually explained by one or more of the following factors:

- insufficient endowment returns over time;
- intergenerational equity concerns which seek to ensure that spending on future generations is at least commensurate with current spending;
- the need to build up the corpus of individual endowment funds in order to earn a sufficient annual investment income that can support the intended purpose or restrictions of the endowed funds; and
- the inability to expend restricted endowment funds due to unmet conditions of the donor (for example, not awarding scholarships, fellowships, or professorships because qualified candidates who meet the donor's specifications could not be found, e.g a donor might endow a scholarship for a low-income female student who majors in dance).

Requiring a minimum five-percent endowment spending rate would needlessly restrict and interfere with the ability of colleges and universities to meet both their near- and long-term fiduciary responsibilities and would likely create complex problems for higher education institutions as they seek to implement binding legal obligations for donor restricted endowment funds.

2. Taxation of Endowments

Ms. Gravelle suggested in her testimony that taxes be imposed on endowments if institutions increased their tuition by more than an appropriate rate such as inflation or the Consumer Price Index. Simply put, this is a form of a federal price control, which would put the federal government in the middle of college pricing decisions.

Throughout history governments have sought to impose price controls. Invariably price control efforts have led to shortages of the commodity or service in question and/or deterioration in quality.

Taxing an endowment's earnings would only increase the upward pressure on tuition and decrease the resources available to support institutional programs, including the student financial aid funds that are crucial to making higher education affordable for families from low- and middle-income backgrounds. In addition, taxing endowments would turn a donor-intended charitable gift into a source of government tax revenue.

3. Greater disclosure of endowment information, investments, and spending

Ms. Munson and some members of the Finance Committee have called for increased disclosure of endowment information. As tax exempt organizations, the higher education community is committed to appropriate transparency and would support appropriate disclosure of key college and university endowment information.

In fact, prior to the Committee's September 26th hearing, the major higher education associations supported increased disclosure of endowment information in the comment letter submitted to the Internal Revenue Service on September 14, 2007 regarding proposed revisions to the IRS Form 990.

Conclusion

Endowments are critical to the colleges and universities that are fortunate to have them. While simplistic policy proposals to force colleges and universities to use their private endowment resources in ways some believe makes most sense may sound appealing, but they are short-sighted and would ultimately reduce the nation's educational resources and research. College and university trustees and administrators take seriously their fiduciary, legal, and moral responsibilities and duties to be long-term and prudent stewards of their institutions' endowments. They know intimately the academic, research, capital, faculty, and student needs of their institutions and communities, and they are best able to make endowment spending decisions for today, tomorrow, and beyond.

Endowments have aided institutions to sustain and improve their educational and research activities for hundreds of years, for many generations of students, through natural disasters, and through wars and economic recessions and depressions. Endowments are once again demonstrating their importance and value today – especially in light of declining public support for state institutions, and increasing national research needs.

The continuing success story of American higher education – and the fact that the U.S. is home to most of the leading colleges and universities in the world – is due in part to the growing and sustained financial resources endowments provide. Our nation continues to be well served by the charitable status colleges and universities receive and the independence afforded them to manage and use their resources as they determine will best meet their education, research, and public service missions.

We thank the Finance Committee for this opportunity to submit this statement for the hearing record.

Statement for the Record

Offshore Tax Issues: Reinsurance and Hedge Funds
September 26 , 2007

Robert Blumenthal
Professor of Mathematics
Oglethorpe University
4484 Peachtree Road, NE
Atlanta, GA 30319

rblumenthal@oglethorpe.edu
404-364-8350

Two leading members of the Senate Finance Committee, Sen. Max Baucus (D-Mont.) and Sen. Charles Grassley (R-Iowa), are trying to increase transparency in the financial reporting by nonprofit organizations. Many of the reforms the senators propose – outlined in a May 29 letter to Treasury Secretary Hank Paulsen -- would have a profound effect upon the kind of financial information that colleges and universities are required to disclose to the public.

Colleges and universities are required to file Form 990 annually with the IRS (available to the public through GuideStar). Baucus and Grassley propose a major overhaul of Form 990. They contend that the current form does not adequately encompass information regarding large, complex nonprofits such as universities. They call for more detailed reporting tailored to the specifics of these institutions and for making their financial reporting more transparent.

A major area of concern for the senators is endowments. They want nonprofit institutions to answer the following questions:

• What is the size of the endowment of the institution, and what definition of endowment is being used to arrive at the figure being reported?

• What is the amount and percentage of the endowment being spent?

• What are endowment funds being spent on?

• What endowment funds are earmarked for specific purposes and what are those purposes?

• How are endowment funds being invested?

• What are the costs of the management of the endowment?

The current Form 990 provides very little insight into these questions, and the situation is made all the more opaque by the fact that there isn't even a uniform definition of "endowment."

In addition to expanding the scope of the information reported on Form 990, Baucus and Grassley want to ensure that the form is filed and made available to the public in a timely fashion. They point out that extensions for filing are routine and that considerable time passes before the document is actually available.

The senators are to be commended for their efforts to bring about greater openness with regard to nonprofits, and the reforms they propose will increase transparency in the financial operations of colleges and universities. I believe, however, that their reforms do not go far enough. In their letter outlining the reforms to Treasury Secretary Henry Paulson, the senators say that it is time to "open the blinds." While a step in the right direction, their proposals would still leave the blinds partially closed, excluding much important light from the eyes of the public.

We should require from colleges and universities -- institutions which enjoy tax-exempt status and which are supported by tax dollars in a myriad of ways -- the same level of transparency with regard to financial matters that we require from public companies, a point made by the two senators. Publicly traded companies are required to disclose their audited financial statements, together with the auditor's notes to those statements. In order to be eligible for federal student aid funds, colleges and universities are required to produce and file a set of audited financial statements with the Department of Education annually. But, unlike the financial statements that publicly traded companies must file, there is no requirement that the financials of a college or university be made public.

All the public gets to see is the Form 990, a very poor substitute. The balance sheet and income statement portions of that form are sketchy at best and are not presented in standard accounting format. Moreover, the 990 includes neither a cash flow statement nor the auditor's notes. In order to guarantee the same level of transparency that currently exists with regard to public companies, Form 990 should be modified to require that a college or university include its audited financial statements, complete with the auditor's notes accompanying them.

Moreover, Form 990 should be made available to the public as soon as possible. Currently, it is not unusual for a college or university to post its Form 990 more than a year after the end of the relevant fiscal year. Public companies are required to furnish financial information in a timely manner. Colleges and universities should do so as well. These institutions should be required to annually furnish the necessary financial information within two months of the end of their fiscal year. Extended delay in providing information is not compatible with transparency.

The senators' call for a uniform definition of endowment is also crucial . For colleges and universities, the term "endowment" can mean whatever the school's governing board wants it to mean. Institutions are free to decide which of their assets to count as endowment and are free to change this determination whenever they choose. In some cases, "endowment" refers only to invested funds which generate income but whose principal cannot be spent. In other cases, it also includes funds designated by the board as "funds functioning as endowment" or "quasi-endowment funds." These are funds labeled by the governing board as endowment, but which may be spent at any time at the discretion of the board. Thus, not only is there no consistency from one institution to the next, but there is also no guarantee of consistency within a single institution from one year to the next.

As long as the concept of endowment remains fuzzy, it will be impossible for the public to evaluate the effectiveness of any nonprofit entity. We need to have a clear definition.

The tax-exempt status enjoyed by colleges and universities is a privilege that should carry certain responsibilities with it. Among those responsibilities should be the requirement to provide, in a timely fashion and on a regular basis, a transparent picture of the financial position and operations of the institution. With that information, parents, donors, and public officials will be better able to evaluate the school's activities.

Statement for the Record
Hearing on Offshore Tax Issues: Reinsurance and Hedge Funds
September 26, 2007

Submitted by: Robert K. Durkee
Vice President and Secretary
Princeton University
Princeton, New Jersey 08544

Chairman Baucus, Senator Grassley, and Members of the Committee: Thank you for the opportunity to submit this written statement on behalf of Princeton University. My name is Robert K. Durkee and I am the Vice President and Secretary of the University.

Princeton is concerned that the witnesses at the committee's September 26th hearing on issues surrounding university endowments presented an incomplete and misleading account of the operation and uses of university endowments, particularly with respect to financial aid. While the comments below will focus specifically on Princeton, I believe that the witnesses' broader mischaracterizations of endowments will be addressed in testimony that is being submitted on behalf of several higher education associations of which Princeton is a member.

Financial Aid

Princeton University was founded in 1746 and one of its earliest endowed funds, dating back to the 18th century, was for financial aid. Today, more than half of Princeton's undergraduates and essentially all of its graduate students receive financial aid.

For many decades Princeton's need-based aid program for undergraduates has been among the strongest in the country. Princeton admits all undergraduates on a need-blind basis and meets the full need of each student who qualifies for aid. Beginning in 2001, student loans have been entirely replaced with grant increases for all students on aid. Princeton also has reduced the summer earnings expectation for students from lower- and moderate-income families. It has reduced the amount that students are expected to contribute from their own savings. It has reduced expected parental contributions by removing home equity from consideration (and giving an equivalent renter's allowance to those who don't own homes). Most recently, last year Princeton reduced term-time job requirements in all aid packages and increased the board allowance for juniors and seniors to reflect actual costs.

These enhancements have been made possible by Princeton's commitment to financial aid as a matter of policy and by excellent stewardship of its endowment over many years. Princeton's endowment is made up of more than 3,500 separate accounts, many of which are restricted to specific purposes, such as faculty positions, academic programs, and student aid. The purpose supported by the largest number of accounts is undergraduate financial aid, and funds from unrestricted accounts are also used to cover the costs of our aid program.

Because financial aid is such a high priority for Princeton, it treats its financial aid budget as an entitlement, not an appropriation. Since Princeton places no limit on the number of aid applicants who can be admitted each year under its need-blind admission process and since it meets the full need of every admitted aid applicant (with grants, not loans), its aid budget fluctuates each year to provide whatever is necessary to carry out this policy. Moreover, because financial aid at Princeton is based solely on a family's ability to pay, annual tuition increases do not in any way increase the amount paid by students on financial aid.

The results of these policies have dramatically broadened the economic diversity of Princeton's student body. For example:

- **Fifty four (54) percent of this year's entering freshman Class of 2011 is receiving financial aid and their average grant award is $31,187.** (Tuition is $33,000 and tuition plus room and a full board contract is $43,980.) In contrast, for the class that graduated in 2001, 38 percent was on financial aid and the average grant award was $15,000.

- This comparison shows a 55 percent increase in the number of students receiving aid over this period of time and a 100-plus percent increase in the average grant. Grants have risen faster than tuition increases, so **while the average grant covered 65 percent of tuition for the Class of 2001, it now covers 96 percent of tuition for the Class of 2011.** Over this same period, students from low-income families (incomes under $53,500 in 2011) have more than doubled, and they now constitute 15 percent of the freshman class. Eleven (11) percent of the members of this year's freshman class are the first in their families to attend college.

- **Princeton's financial aid program also supports middle-income families and even upper-middle income families with multiple obligations.** For example, nearly all families with incomes between $100,000 and $140,000 who applied for aid this year qualified and they received average grants of $26,480. Of families with incomes between $140,000 and $200,000 who applied for aid, 90 percent qualified for an average grant of $18,080. Even families whose income levels allow them to pay Princeton's full annual fee are paying only about half of what it costs to provide their children with the kind of education Princeton offers. This is reflected in the fact that more than half of Princeton's $1.2 billion operating budget is supported by spending from the endowment (44 percent) and annual gifts (8 percent). If you exclude funding for sponsored research and net out expenditures for financial aid, the fraction of the budget supported by endowment earnings and gifts is 78 percent. Princeton held tuition level this year (while increasing charges for room and board to reflect actual costs), but it has not believed that families that can afford to help pay for their children's educations should not be asked to do so.

- **Because of Princeton's no-required-loan policy, student debt at graduation has plummeted** from $13,820 for the Class of 2001 to an expectation of $2,700 for the Class of 2011. This borrowing is entirely voluntary since students are not required to borrow as part of their financial aid package.

To fund its extensive aid program, Princeton relies heavily on its own resources. More than 92 percent of the University's $81 million scholarship budget for 2007-8 is being provided from University endowed and yearly sources, especially annual gifts from alumni, and more than 80 percent—more than $65 million—is from the endowment. By contrast, only about 3 percent (about $2.5 million) of the scholarship budget comes from federal programs. Strikingly, the University's scholarship budget this year is greater than its net tuition revenues; while the scholarship budget is $81 million, its net tuition revenue is only $75 million.

Princeton is able to offer such a generous financial aid program because of the generosity of donors who have contributed to the endowment and donors who make annual gifts for financial aid, and because of the exceptional performance of the endowment over many years. Princeton's endowment income spending policy calls for a stipulated increase in spending each year from each endowment account, with a target spending rate between 4 and 5.75 percent. Under this policy, payout rates vary (up and down) with changes in the value of the endowment. Our current payout rate is well within the range at roughly 4.6 percent.

We have done careful and extensive research that suggests that the range we have adopted will allow us to maximize current spending while also sustaining the purchasing power of the endowment into the future so we can continue to honor our current commitments and meet new needs as knowledge increases and new fields emerge. This research also confirms the wisdom of allowing for fluctuation across the range rather than locking in a specific percentage, especially for institutions, like universities, that require short- and long-term stability so they can make long-term commitments. While grant-making institutions, like foundations, can adjust their allocations downward in lean years, universities need to be able to sustain their commitments even in challenging financial times.

In fact, when endowment spending represents a large share of an operating budget's revenues as it does at Princeton, it is especially critical that there be stability in the dollar amounts spent from year to year. If spending levels are sustained, then spending rates (dollars spent per unit of endowment divided by unit market value of the endowment) will fluctuate with the endowment's unit market value. One consequence is that contrary to what was suggested by one witness, these institutions must spend at ***higher***, not lower, rates during periods of weak investment performance. This need for stability in the dollar spending stream means that spending rates will drift down when investment returns are strong. When investment returns are especially strong over a period of time (as they have been recently), Princeton's policy is to make upward adjustments to remain within its target range, and it has made these adjustments nine times in the past 30 years (including three times in the past 18 months). A major beneficiary of these adjustments has been financial aid.

Other Endowment Spending

Princeton is a major research university that is distinctive in its commitment to undergraduate teaching, and it relies on its endowment to provide an educational program that is based on extensive interaction between students and faculty. The ratio of full-time undergraduates to faculty members is 5:1, and every senior must complete a thesis or similar project based on original research, working directly with a member of the faculty. All faculty members at Princeton teach (including the president), and the teaching program is supported by one of the world's most distinguished research libraries; its holdings include more than 6.5 million books, 6 million microforms, 30,000 linear feet of manuscripts, and distinguished holdings of rare books, prints, archives, and other materials that require special handling. The teaching program is also supported by an excellent art museum, laboratories and other classroom spaces, and information technologies that are now indispensable to teaching and learning. Princeton also offers its students extensive opportunities to develop their talents and leadership skills through extracurricular, athletic, and community service programs.

Princeton takes very seriously its obligations to manage its endowment in a manner that will achieve a sustainable balance between providing as much support as possible for the current generation at Princeton while also building capacity to meet future needs. Spending levels must permit sufficient reinvestment of revenues so that, over time, the per-unit value of the endowment keeps pace with rising costs and the University is able to provide each new generation of students with an education that encompasses both the newest technologies and the newest fields of knowledge.

This country's leading universities rank among the best in the world, and they have achieved this position, in part, through the generosity of their donors and the careful stewarding of their resources. Their investment and spending policies must reflect long-term earnings experience (over lean years as well as favorable ones), although, as already noted, periodic upward adjustments in spending can be made and are made in response to exceptionally strong short-term performance. These policies also must provide long-term stability since universities, unlike foundations, must be able to make long-term commitments to faculty (many of whom are world leaders in their fields), academic programs, and to the facilities (including state-of-the-art laboratories and libraries) that are essential to world class teaching and research.

A Princeton trustee summarized the obligations of the trustees, who are charged with ultimate responsibility for managing the endowment and adopting the annual budget, as follows: "One of the most important responsibilities of the trustees is to try to find the right balance between achieving the highest possible standards of excellence for this generation and ensuring the University's financial capacity to continue to achieve those standards for future generations." Princeton's provost, Christopher Eisgruber, has written: "Our spending policy serves to provide budgetary stability, but even more important, it is designed to ensure intergenerational equity. It would be inappropriate for Princeton to spend so much today that it could not offer comparable opportunities to later generations of students and researchers. And conversely, it would be inappropriate to deny new opportunities to Princetonians today in order to focus exclusively on their successors."

In addition to expenditures on financial aid, Princeton uses its endowment and annual gifts to help meet the significant and expanding human and capital needs of a community devoted to the discovery, preservation, and transmission of knowledge. There are thriving fields at Princeton today, ranging from computer science to nanotechnology and from environmental studies to genomics that could not have been imagined even 25 years ago, and there are emerging fields now, with neuroscience as a prime example, that are poised to make transformative discoveries over the coming years. If we want these discoveries to be made in this country and want our students to be educated by leaders in these fields, our leading universities have to be able to invest not only in the research, but in the faculty, students, and facilities needed to conduct the research. Strong endowments make these investments possible, along with investments that strengthen teaching programs in other ways, such as Princeton's program that requires each undergraduate to participate in specially designed writing seminars to make sure they learn to write clearly, cogently, and persuasively.

In short, many of the needs of a major research university such as Princeton could not have been anticipated years ago. Princeton's careful management of its endowment has allowed it to meet these needs, while also opening the doors to Princeton wider than ever to students from all economic backgrounds. This country has been well served by encouraging taxpayers to make contributions to universities so they can strive for the highest standards of excellence and opportunity, and by expecting that universities will manage and utilize their resources responsibly in pursuit of these objectives.

October 5, 2007

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