



Opening Statement of Senator Chuck Grassley
Hearing, Offshore Tax Issues: Reinsurance and Hedge Funds
September 26, 2007

Thank you Chairman Baucus, for calling this hearing on selected international tax issues. This morning, we will examine three seemingly discrete issues: (1) offshore reinsurance; (2) the use of offshore “blocker” corporations by domestic tax-exempt organizations to make hedge fund investments; and (3) the practice of deferring compensation by U.S. hedge fund managers with respect to offshore hedge funds.

We are in an increasingly global economy. U.S. businesses face foreign competitors here at home and 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 compete in foreign markets. We tax foreign-owned businesses only on their income that is sufficiently connected to the U.S. 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 rules provide one example.

Our international tax system can affect the competitiveness of U.S. businesses both here and abroad. The insurance industry, which we are examining today, illustrates this 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, Germany, Switzerland, and Bermuda. But Bermuda has received the most attention. One industry publication refers to the Bermuda reinsurance model as a “better mouse trap” for insuring U.S. risks 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’s 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. This hearing will help with this analysis.

The other two issues we'll be examining relate to offshore hedge funds. We've all seen the picture of the Ugland House in the Cayman Islands as the registered address for 12,748 companies. A good number of those companies are there because of hedge fund investment structures.

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 a carried interest. For the investor, this serves the objective of permitting a de facto deduction for the manager's fee that would otherwise be limited. For the fund manager, it permits some conversion of ordinary income to capital gain 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 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 an unlimited portion of the incentive fee through a nonqualified 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'll be looking at these issues at today's hearing. The principal purpose of this hearing is to examine offshore reinsurance and hedge fund issues. I look forward to hearing testimony on these issues. But first, we'll hear from Senator Dorgan, who will discuss his proposed legislation.