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JUL 3 1 2014

Honorable Ron Wyden
United States Senate
SD-221
Washington, D.C. 20510

Dear Chairman Wyden:

This is in response to your inquiry about offshore reinsurers that are owned by or that invest in hedge funds.

The enclosed document provides background on the hedge fund reinsurance structure and business and tax advantages to that structure; a description of legislative proposals in the area; and background on hedge funds and data on offshore reinsurance broadly and in Bermuda specifically.

I hope this information is helpful to you. If we can be of further assistance in this matter, please let me know.

Sincerely,

Thomas A. Barthold

Thomas A. Barthold

cc: David Berick, Todd Metcalf, Kara Getz, and Chris Law

Enclosure

BACKGROUND AND DATA WITH RESPECT TO HEDGE FUND REINSURANCE ARRANGEMENTS

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

July 30, 2013

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A. Background on Hedge Fund Reinsurance

Introduction

The establishment of offshore businesses that reinsure risks and that invest in U.S. hedge funds has been characterized as creating the potential for tax avoidance.[1] In these arrangements, a hedge fund or hedge fund investors make a capital investment in an offshore reinsurance company. The offshore reinsurance company then reinvests that capital (as well as premiums it receives) in the hedge fund.

The reinsurer is a corporation. Its owners take the position that they are not taxed on corporate earnings until those earnings are distributed or the investors sell the corporation's stock at a gain reflecting those earnings. U.S. tax rules designed to prevent tax deferral through offshore corporations provide an exception for income derived in the active conduct of an insurance business. How much insurance or reinsurance business the company must do to qualify for this exception may not be completely clear.[2]

The hedge fund reinsurance arrangement is said to provide indefinite deferral of U.S. taxation of the hedge fund's investment earnings such as interest and dividends. At the time the taxpayer chooses to liquidate the investment, ordinary investment earnings are said to be converted to capital gains, which are taxed at a lower rate. The use of offshore reinsurance companies allows large-scale investments that are said to be consistent with capital and reserve requirements applicable to the insurance and reinsurance business.

Structure

Hedge fund reinsurance arrangements are structured by creating a new foreign reinsurance company in a low-tax offshore jurisdiction. The reinsurer is a corporation subject to the regulatory regime of the offshore jurisdiction. The reinsurer takes on insured risks originally underwritten by other insurance companies through reinsurance contracts with those insurers. The reinsurer receives premiums for taking on the risks, and sets up reserves to back up the risks.

The reinsurance contracts may be arranged or brokered by a facilitator engaged in or familiar with the reinsurance business. The process of underwriting (assessment and selection) of risks to be reinsured may be contracted out to the facilitator. The facilitator may hold an equity interest in the reinsurer or have a right to earnings based on investment performance of the reinsurer's assets.

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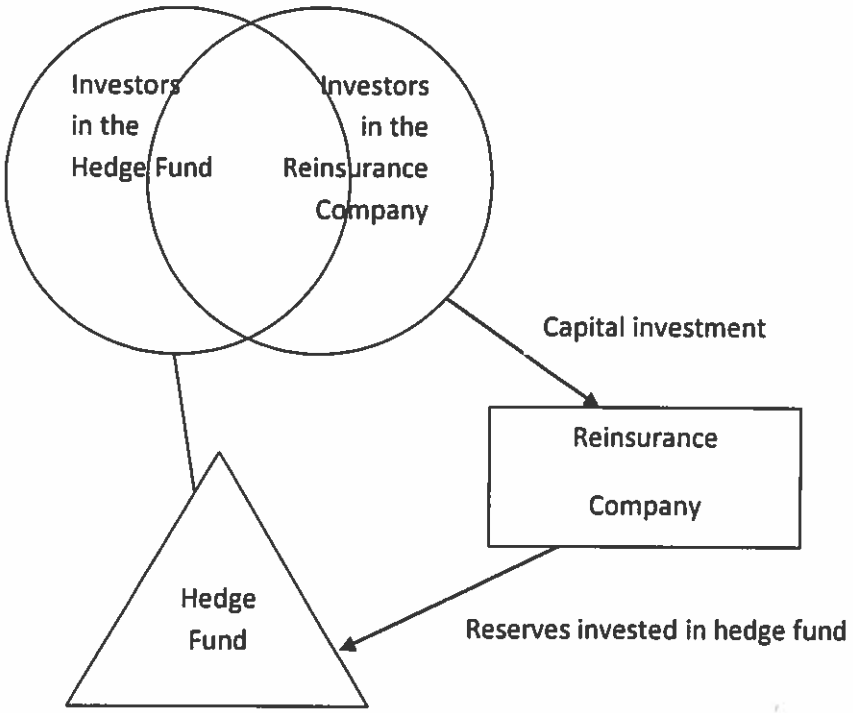
[1] See, for example, Victor Fleischer, "Why Hedge Funds Don't Worry About Carried Interest Tax Rules," *New York Times*, Dealbook, May 14, 2014: "...[M]any top hedge fund managers have entered the business of reinsurance, using Bermuda-based reinsurance companies as a capital base for investment in their hedge funds. Insurance companies must hold capital in reserve, and there is nothing to stop an insurance company from holding a huge reserve and investing that capital in a hedge fund. By stapling a small reinsurance business onto billions of dollars of hedge fund capital, any profits can be indefinitely deferred from tax offshore. Better yet, when the fund manager sells an interest in the Bermuda company, the gain may be taxed at the lower long-term capital gains rates."

[2] See IRS Notice 2003-34, 2003-C.B. 1 990, June 9, 2003, and discussion of tax advantages, below.

The reinsurer is capitalized by a U.S. hedge fund and/or some or all of the hedge fund's investors and managers. They contribute the bulk of the reinsurer's capital in exchange for ownership of a significant part of the value of the reinsurer.

The capital invested in the reinsurer, as well as the premiums the reinsurer sets aside as reserves for reinsured risks, are invested largely or in part in the U.S. hedge fund. In some cases, the reinsurer may diversify its ownership structure by going public, resulting in significant public ownership of the voting stock (but not necessarily the value) of the company.



Business advantages

The investment of the reinsurer's reserves in the U.S. hedge fund has the business advantage to the hedge fund of keeping capital in the hedge fund without much risk that the investor will withdraw large amounts unexpectedly, if the reinsurer and its owners are related to the hedge fund or are seeking hedge fund investment returns. Further, the reinsurer may choose to invest very large amounts with the hedge fund. Reserve assets generally are required by insurance regulators to back up future payment of claims, if any, with respect to the reinsured risks. If the reinsured risks are potentially large and the likelihood of the insured event is unpredictable or difficult to model, an argument is made that the reserves should be very large to support the worst case scenario. For example, a natural catastrophe such as a hurricane may be unlikely or at least hard to predict, but the potential damage could be enormous. Alternatively, other types of risks can be reinsured that are considered to be relatively low-risk, or that have relatively predictable claims payment patterns which dovetail with the hedge fund's investment strategy.

Similarly, the reinsurer's reserve assets may be large, for example, due to possible volatility in the investment performance of the underlying hedge fund in which the assets are invested. This type of volatility depends on the investment strategy of the hedge fund. Alternatively, if a large part of the reinsurer's reserve assets are invested in a single hedge fund, regulators may require a larger reserve to be maintained than would be required to support the same risks using more diversified investments. This may be advantageous for the hedge fund, as more investment income is tax-advantaged, as explained below, for assumption of a relatively small amount of insurance risk.

Tax advantages

A U.S. investor in a hedge fund which is a partnership generally must include its share of partnership income in the year realized and recognized by the partnership, whether or not it is distributed.[3] Investors in hedge funds include high net worth individuals, institutional investors such as endowment funds and pension plans, and corporate investors, including insurance companies.

A U.S. investor in a hedge fund reinsurance arrangement, by contrast, might achieve the tax advantages of indefinite deferral, selective realization, and conversion of ordinary income to capital gain.

A U.S. shareholder in a foreign entity is generally required to include its share of passive or highly mobile income currently, even if not distributed,[4] in accordance with the anti-deferral regimes of current U.S. tax law. However, the hedge fund reinsurance arrangement is generally structured to avoid the subpart F[5] anti-deferral rules and the passive foreign investment company ("PFIC")[6] anti-deferral rules.

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[3] Secs. 701and 702 of the Internal Revenue Code (the "Code"). A partnership is treated as a passthrough entity for Federal tax purposes. The use of a blocker corporation interposed between the hedge fund partnership and the investor may mitigate the investor's current income inclusion, as a practical matter. The blocker corporation is taxed on its share of the hedge fund's partnership income, and is not, itself, a passthrough entity. Thus, the investor is taxed on income derived from the hedge fund only when the blocker corporation distributes the income (for example, as a dividend). U.S. tax paid by the blocker corporation might, moreover, be reduced or eliminated if the blocker corporation has tax deductions or credits that offset the income inclusion. For example, the blocker corporation may be highly leveraged and may deduct significant interest expense with respect to the leverage.

[4] Or with an interest charge when distributed.

[5] Secs. 951-964. Under the subpart F rules, the United States generally taxes the 10-percent or greater U.S. shareholders of a controlled foreign corporation ("CFC") on their pro rata shares of certain income of the CFC (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders.

[6] Secs. 1291-1298. A PFIC is generally defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income (sec. 1297). A U.S. person who is a shareholder of a PFIC is subject to U.S. tax in respect of that person's share of the PFIC's income under one of three alternative anti-deferral regimes, regardless of the percentage ownership in the company. One set of rules applies to passive foreign investment companies that are "qualified electing funds," under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax,

The hedge fund reinsurance arrangements generally keep U.S. investors' ownership interests below the 10-percent voting threshold generally applicable for defining a U.S. shareholder under the applicable subpart F rules. The arrangements may be structured to ensure the risks reinsured are not related party risks with respect to which the ownership threshold for a U.S. shareholder is lower.[7]

The PFIC anti-deferral regime of present law provides an exception for income derived in the active conduct of an insurance business. This exception applies if the insurance business is conducted by a corporation that is predominantly engaged in an insurance business and that would be subject to the Federal tax rules applicable to insurance companies if it were a domestic corporation.[8]

In Notice 2003-34,[9] the Internal Revenue Service identified issues in applying the insurance exception under the PFIC rules. One issue involves whether risks assumed under contracts issued by a foreign company organized as an insurer are truly insurance risks, and whether the risks are limited under the terms of the contracts.

In the Notice, the Service also analyzed the status of the company as an insurance company. The Service looked to Treasury Regulations issued in 1960 and last amended in 1972,[10] as well as to the statutory definition of an insurance company[11] and to the case law. The question to resolve in determining a company's status as an insurance company is whether "the character of all of the business actually done by [the company] ... indicate[s] whether [the company] uses its capital and efforts primarily in investing rather than primarily in the insurance business." The Notice concluded that "[t]he Service will scrutinize these arrangements and will apply the PFIC rules where it determines that [a company] is not an insurance company for federal tax purposes."[12]

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subject to an interest charge, on income not currently received (secs. 1293-1295). A second set of rules applies to passive foreign investment companies that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral (sec. 1291). A third set of rules applies to PFIC stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market" (sec. 1296).

[7] See secs. 951(b) and 953(c).

[8] Sec. 1297(b)(1)(B).

[9] IRS Notice 2003-34, 2003-C.B. 1 990, June 9, 2003.

[10] Treas. Reg. sec. 1.801-3(a).

[11] Secs. 831(c) and 816(a).

[12] IRS Notice 2003-34, above.

On June 12, 2014, Senator Ron Wyden, Chairman of the Senate Committee on Finance, sent a letter to the Treasury Department and the Internal Revenue Service inquiring why no progress had been made in ending the "tax abuse" identified with respect to hedge fund reinsurance in Notice 2003-34.[13]

The applicability of the PFIC insurance exception involves a factual analysis, and the minimum level of reinsurance activity necessary to qualify for this exception may not be completely clear. Some commentators have queried whether a hedge fund can be disguised as a reinsurance company.[14] The hedge fund's investors seek to avoid U.S. tax by structuring the hedge fund's activities and investments to engage in the minimum insurance business necessary for the PFIC insurance exception, whatever that minimum is.

In addition to the hedge fund's managers and investors who benefit from reserve earnings that are untaxed under the PFIC insurance exception, other parties to the arrangement may take advantage of the claimed tax benefits of hedge fund reinsurance arrangements. These parties may include insurance companies ceding risks to the reinsurer, other reinsurers that assume risks from the hedge fund reinsurer, or facilitators that perform underwriting or other services. When an insurance company cedes a risk to a reinsurer, the ceding company ordinarily pays a reinsurance premium to the reinsurer. Commission payments may also be part of the transaction. Payments may go both ways between the ceding company and the reinsurer. Further, the hedge fund reinsurance company may in turn offload some risks by reinsuring them with another reinsurer. Ceding insurers, reinsurers, or facilitators that broker risks or perform risk underwriting services on a contractual basis under the hedge fund reinsurance arrangement may contract for a right to tax-advantaged earnings based on the hedge fund's investment performance.

History and growth of hedge fund reinsurance

Media attention to hedge fund reinsurance has described the practice as dating from an arrangement set up in 1999.[15] Since that time, other well-known hedge fund managers have

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[13] Letter of Senator Wyden to the Honorable Jacob J. Lew, Secretary of the Treasury, and the Honorable John Koskinen, Commissioner, Internal Revenue Service, June 12, 2014, reported in Zachary R. Mider, "Senate's Wyden Pushes IRS Over Hedge-Fund Tax Strategy," Bloomberg News, June 17, 2014, http://www.businessweek.com/news/2014-06-17/senate-s-wyden-pushes-irs-over-hedge-fund-tax-strategy .

[14] Lee Sheppard, "News Analysis - Hedge Funds in Insurance Wrappers," 96 *Tax Notes* 1671 (September 23, 2002), http://services.taxanalysts.com/taxbase/taxnotes.nsf/SearchIndex/74BC341A8633D46F85256C3E00435CFB?OpenDocument&highlight=0,Hedge%2520Funds%2520in%2520Insurance%2520Wrappers ; Andrew W. Needham and Christian Brause, "Hedge Funds Disguised as Insurance Companies" in *Hedge Funds*, 736 Tax Management Portfolio pages A-101 - A-102 (2007).

[15] Zachary Mider, "Paulson Leads Funds to Bermuda Tax Dodge Aiding Billionaires," *Bloomberg News*, February 19, 2013, http://www.reactionsnet.com/Article/3349941/Search/Results/Bermuda-strengthens-its-position.html?Keywords=hedge+fund&OrderType=1 : "The first prominent hedge fund to set up a large Bermuda reinsurer was Louis Bacon's New York-based Moore Capital Management LP, in 1999."; Hal Lux, "The Great Hedge Fund Reinsurance Tax Game," *Institutional Investor*, April 2001, pages 52-58, http://www.institutionalinvestor.com/Article/1027978/The-Great-hedge-fund-reinsurance-tax-game.html : "When U.S. investors invest directly in hedge funds, they must pay annual taxes on realized profits, usually at the high

established hedge fund reinsurance arrangements in low-tax jurisdictions such as Bermuda or the Cayman Islands.[16]

Recently, facilitators of hedge fund reinsurance arrangements have been have been described in news reports or advertisements. For example, an accounting firm advertising assurance, tax, transaction, and advisory services on line for hedge fund-backed reinsurers points to the advantages to asset managers of raising assets under management, permanent capital, free money to invest, ability for the asset manager to monetize its value, and investor relations.[17] A reinsurance venture that seeks to enable asset managers, such as hedge fund managers, to enter the reinsurance market has participated in the launch of reinsurance companies during 2013 and

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ordinary income rate. But thanks to special tax treatment for insurers, when individuals buy into an outfit like Max Re that invests in hedge funds, they in effect pay nothing on the trading profits until they sell shares of the company: Then they are taxed at the lower capital gains rate."

[16] Lee Sheppard, "News Analysis: Money Talks: Hedge Fund Reinsurance Companies," *Tax Notes*, March 18, 2013, http://services.taxanalysts.com/taxbase/taxnotes.nsf/SearchIndex/0CE6A4297D3328B785257B32000C4100?OpenDocument&highlight=0,hedge,fund,reinsurance : "Giant hedge funds Greenlight Capital (David Einhorn), SAC Capital (Steven Cohen), and Third Point Capital (Daniel Loeb) all founded reinsurance companies that they have taken public. According to Bloomberg, these companies account for nearly $2 billion of reinvestment in their sponsors. They followed in the footsteps of Moor Holdings (Louis Bacon), which formed publicly traded Max Re in 1999."; Christopher Munro, "Bermuda Strengthens its Position," *Reactionsnet.com*, June 9, 2014, http://services.taxanalysts.com/taxbase/taxnotes.nsf/SearchIndex/0CE6A4297D3328B785257B32000C4100?OpenDocument&highlight=0,hedge,fund,reinsurance : "Several new hedge fund-backed reinsurers have set up shop in Bermuda in recent times, and there are rumours others are on their way. The aforementioned Duperreault heads up Hamilton Insurance Group, while Third Point Re and Pac Re have also opened for business. On top of that, JP Morgan Asset Management Holdings Inc subsidiary Highbridge Capital teamed up with Arch Re to launch Watford Re. Pine River Capital Management is also known to be considering an entry into Bermuda's reinsurance space, although the company has not yet constructed a full team to initiate the launch.". But see, "SAC Re placed under review by AM Best," *Reactionsnet.com*, July 30, 2013, http://www.reactionsnet.com/Article/3237585/SAC-Re-placed-under-review-by-AM-Best.html?ArticleID=3237585&LS=EMS867332 : "AM Best has placed its ratings of SAC Re under review with negative implications reflecting the rating agency's concerns about the company's business plan being 'challenged.'".

[17] "Leading the way: hedge fund-backed reinsurers generate AUM and permanent capital for asset managers," 2013, http://www.ey.com/Publication/vwLUAssets/EY_-_The_growth_of_hedge_fund-backed_reinsurers/$FILE/EY-Leading-the-way.pdf .

2014.[18] At least one other existing reinsurer is reported to have participated in the formation of a hedge fund reinsurance arrangement.[19]

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[18] Artemis, "Hyaline Re the latest hedge fund backed reinsurer panning launch," www.artemis.bm, February 20, 2014, http://www.artemis.bm/blog/2014/02/20/hyaline-re-the-latest-hedge-fund-backed-reinsurer-planning-launch/ ; Artemis, "Hedge fund style reinsurer Swan Re launches on Multi-Strat platform," February 6, 2014, http://www.artemis.bm/blog/2014/02/06/hedge-fund-style-reinsurer-swan-re-launches-on-multi-strat-platform/ ; Artemis, "Resource Re Ltd., first Multi-Strat Re reinsurer, raising capital," www.artemis.bm, September 30, 2013, http://www.artemis.bm/blog/2013/09/30/resource-re-ltd-first-multi-strat-re-reinsurer-raising-capital/ ; Artemis, "Multi-Strat Re to make it easier for hedge funds to get into reinsurance," www.artemis.bm, September 28, 2012, http://www.artemis.bm/blog/2012/09/28/multi-strat-re-to-make-it-easier-for-hedge-funds-to-get-into-reinsurance/ .

[19] Steven Davidoff Solomon, "With Lax Regulation, a Risky Industry Flourishes Offshore," Deal Book, *New York Times,* September 4 2012, http://dealbook.nytimes.com/2012/09/04/with-lax-regulation-a-risky-industry-flourishes-offshore/?_php=true&_type=blogs&_r=0 : "Yet the concern is not that so much of the business is offshore, but that the growing role of hedge funds may push the main reinsurers to be more aggressive with their own investing. The result would be to push the reinsurance market into becoming a giant hedge fund industry. We're already seeing some movement in this direction. The big reinsurer Validus is forming the Bermuda-based PaCRe with the hedge fund magnate John Paulson's Paulson & Company." See also David Benyon, "Bermuda's Reinsurance Market Reinvented," *Reactionsnet.com*, February 4, 2013, http://www.reactionsnet.com/Article/3150771/Search/Results/Bermudas-reinsurance-market-reinvented.html?Keywords=reinsurance+market+reinvented&OrderType=1

B. Legislative Tax Reform Proposals in 2013 and 2014 Relating to the Insurance Exception to Anti-Deferral Rules

Description of Ways and Means Committee Chairman Camp's Tax Reform Discussion Draft Proposal[20]

The proposal modifies the requirements for a corporation the income of which is not included in passive income for purposes of the PFIC rules. The proposal replaces the test based on a whether a corporation is predominantly engaged in an insurance business with a test based on the gross receipts of the corporation consisting of premiums. The requirement that the foreign corporation would be subject to tax under subchapter L if it were a domestic corporation is retained.

Under the proposal, passive income does not include income derived in the active conduct of an insurance business by a corporation (1) more than 50 percent of the gross receipts of which for the taxable year consist of premiums; (2) that would be subject to tax under subchapter L if it were a domestic corporation; and (3) the applicable insurance liabilities of which constitute more than 35 percent of its total assets as reported on the company's applicable financial statement for the year.

For purpose of this 35-percent test, applicable insurance liabilities means (1) loss and loss adjustment expenses (including property and casualty insurance risks), (2) unearned premiums, and (3) reserves (other than deficiency or contingency reserves) for life and health insurance risks and life and health insurance claims with respect to contracts providing coverage for mortality risks (not to exceed the amount of such reserve that is required to be reported to the home country insurance regulatory body). An applicable financial statement is a statement for financial reporting purposes that (1) is made on the basis of generally accepted accounting principles or international financial reporting standards, or (2) except as otherwise provided by the Secretary in regulations, is the annual statement required to be filed with the home country insurance regulatory body.

The proposal applies to taxable years beginning after December 31, 2014.

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[20] The international proposals are described in more detail in Joint Committee on Taxation, *Technical Explanation of the tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title IV — Participation Exemption System for the Taxation of Foreign Income* (JCX-15-14), February 26, 2014.

Description of Senator Baucus's Tax Reform Staff Discussion Draft Proposal[21]

The discussion draft, Option Y, modifies the definition of subpart F income. The discussion draft's passive income definition for subpart F purposes also provides the definition of passive income for the purposes of the passive foreign investment company ("PFIC") rules, subject to certain limited exceptions. Foreign personal holding company income, which is a type of subpart F income, does not include qualified banking or financing income of an eligible CFC or qualified insurance income of a qualifying insurance company, under the Option Y discussion draft. The provision revises the definition of a qualifying insurance company to better address current international insurance market practices and to better address abuse.

The provision retains certain present-law rules defining requirements applicable to a qualifying insurance company. Thus, the provision retains the requirement that a qualifying insurance company be subject to home country regulation. The provision retains the requirement that a qualifying insurance company derive more than 50 percent of aggregate net written premiums from contracts not involving related persons; however, the provision does not retain the present-law requirement that it derive more than 50 percent of aggregate net written premiums from contracts covering home country risks. The provision retains the requirement that a qualifying insurance company be engaged in the insurance business and that it would be subject to tax under subchapter L if it were a domestic corporation.

The provision adds two new requirements for qualifying insurance company status.

The discussion draft requires that more than 50 percent of the CFC's gross receipts for a taxable year consist of premiums for insurance or reinsurance in connection with property, liability, or the lives or health of individuals, that are treated as earned by such CFC in its home country for purposes of tax laws in the home country of the CFC.

In addition, the provision requires that the CFC's applicable insurance liabilities constitute more than 35 percent of the CFC's total assets as reported on the company's applicable financial statement for the year with or within which the taxable year ends. Insurance liabilities are defined as loss and loss adjustment expenses, unearned premiums, and reserves (other than catastrophe, deficiency, equalization, or similar reserves) for life and health insurance risks and life and health insurance claims with respect to contracts providing coverage for mortality or morbidity risks (not to exceed the amount of such reserve that is required to be reported to the home country insurance regulatory body).

The CFC's applicable financial statement for this purpose means the statement for financial reporting purposes that is made on the basis of generally accepted accounting principles or (if not made on the basis of generally accepted accounting principles) is made on the basis of

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[21] The international proposals are described in more detail in Joint Committee on Taxation, *Technical Explanation of the Senate Committee on Finance Chairman's Staff Discussion Draft of Provisions to Reform International Business Taxation* (JCX-15-13), November 19, 2013. Related concepts are included in Option Z of the staff discussion draft.

international financial reporting standards. If a CFC does not make such a financial statement, then the applicable financial statement is the annual statement required to be filed with the home country insurance regulatory body, except as otherwise provided by the Secretary.

The percentage tests generally are applied on a CFC-by-CFC basis (or branch-by-branch basis); however, regulatory authority is provided to determine circumstances (if any) under which it is appropriate and consistent with the purposes of the provision to apply the percentages by treating all CFCs filing a consolidated tax return, including a home country consolidated tax return, as one CFC. Further regulatory authority is provided with respect to the application of the 50-percent premiums test and the 35-percent insurance liabilities test in the case of a startup or runoff company. In the absence of guidance, it is intended that rules apply for this purpose that are similar to those applicable under section 815, providing generally that in the case of a startup or runoff company, a company without adequate premiums for two successive taxable years cannot be treated as an insurance company.

C. Data and Analysis of Hedge Fund Reinsurance Arrangements

Historical background on hedge funds

Hedge funds are private pooled investment limited partnerships generally limited to high net worth individual investors or large institutional investors. Alfred W. Jones is credited with launching the first hedge fund in 1949.[22] Jones earned a Ph.D. in sociology from Columbia University and joined the editorial staff of *Fortune* magazine. While conducting research for an article on market technical analysis, he started thinking about ways in which a fund could invest its capital in the markets while lowering its exposure to market fluctuations.[23] He is credited with launching the first hedged fund, as he called it, when in 1949 with $100,000 he started using short sales and leverage to "hedge" the risk of long positions in the stock market.[24] In 1952, Jones reorganized his fund as a limited partnership and established what has become the industry standard rule that the general partner would keep 20 percent of fund profits. By the mid-1950s, other funds started using short-selling strategies, although most did not focus on hedging market risk.[25] By 1990, hedge fund assets under management amounted to less than $50 billion.[26]

Hedge fund industry size

In recent years, the industry has experienced rapid growth due to both the influx of new capital and market appreciation. Estimates of the size of the industry vary, as the definition of what constitutes a hedge fund may overlap with other types of investment funds. However, one source estimates, that as of the end of 2013, the industry had grown to an estimated $2.85 trillion in assets under management worldwide, up from an estimated $2.6 trillion at the end of 2012. The largest 100 funds alone managed $1.51 trillion, or 53 percent of the fund industry's assets.[27]

Hedge fund investment strategies

In addition to the growth in size, hedge funds have expanded the scope of investment strategies to a wide array of strategies which vary in returns, volatility, and use of leverage.

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[22] A. W. Jones, History of the Firm, http://www.awjones.com/historyofthefirm.html

[23] Peter Landau, "The Hedge Funds: Wall Street's New Way to Make Money," *New York Magazine*, 1:29, October 21, 1968, pp. 19-24.

[24] Short sales involve the sale of a borrowed security that the seller does not own, usually with the expectation that the security will drop in price. If so, the short seller makes money by buying the security at the lower price to pay off the borrowed shares. A long position is one in which the investor owns the security outright.

[25] Isaac Ruiz-Carus, Varun Bhat, and Emily Marriott, "What is a Hedge Fund?", The University of Iowa Center for International Finance and Development, available at http://www.uiowa.edu/ifdebook/faq/Hedge.shtml

[26] Rene M. Stulz, "Hedge Funds: Past, Present, and Future." *Journal of Economic Perspectives*, 21, Spring 2007, pp. 175-194.

[27] Stephen Taub, "The 2014 Hedge Fund 100: The World's Top Hedge Funds," InstitutionalInvestor'salpha.com , May 12, 2014, http://www.institutionalinvestorsalpha.com/Article/3340199/The-2014-Hedge-Fund-100-The-Worlds-Top-Hedge-Funds.html .

Because of the restriction to accredited investors,[28] hedge funds are not subject to the same regulation as other entities and typically have more flexibility in the investment options available to them. Strategies may have a broad degree of exposure to market movements (directional), low correlation to overall market movements (market-neutral), attempt to profit from perceived pricing inefficiencies related to specific events (event-driven), or represent some combination of the above. This combination strategy is most common in the "fund of funds" segment of the industry, which includes closed-end registered investment companies that invest in other existing hedge funds.

Offshore reinsurance data

According to the reinsurance industry national trade association, the Reinsurance Association of America, $65.7 billion of U.S. premiums were ceded to offshore reinsurers in 2013, $28.4 billion of which was ceded to unaffiliated offshore reinsurers and $37.4 billion of which was ceded to affiliated offshore reinsurers. The top countries ranked by total reinsurance premiums ceded by U.S. insurers are Bermuda ($32.3 billion), Switzerland ($11.8 billion), the United Kingdom ($6.4 billion), Germany ($5.2 billion), and the Cayman Islands ($4.6 billion).[29]

Hedge fund reinsurance data

The following section provides data on various offshore reinsurance companies. As the benefits to owners of these companies are maximized when the profits of the reinsurance company are not subject to corporate level income tax, and because Bermuda is the largest market for reinsurance of U.S. premiums, data are presented on firms headquartered in Bermuda, which has no corporate income tax.

The Bermuda Monetary Authority is the financial services sector regulator in Bermuda. It requires Class 4 and Class 3B insurers to file audited financial statements as part of their annual filings, which it subsequently publishes. Class 4 insurers are those that underwrite direct excess liability insurance and/or property catastrophe reinsurance risks and are required to maintain capital and surplus of $100 million. Class 3B insurers are large commercial insurers 1) whose percentage of unrelated business represents 50 percent or more of net premiums written or net loss and loss expense provisions; and 2) where the unrelated business net premiums are more than $50 million. Class 3B insurers are required to maintain capital and surplus of $1 million. The Bermuda Monetary Authority does not publish financial statements for companies whose

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[28] Under the Securities Act of 1933, a company that sells its securities to accredited investors may be exempt from registration requirements with the Securities and Exchange Commission. An accredited investor is defined in Rule 501 of Regulation D to include, among others, "any natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000" excluding the person's primary residence, and "any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year[.]" 17 CFR 230.501(a).

[29] Data are reported by the Reinsurance Association of America based on ceded reinsurance as reported in annual statements filed with the NAIC. Reinsurance Association of America, *Offshore Reinsurance in the U.S. Market*, 2013 Data, available at http://www.reinsurance.org/offshorereport/.

unrelated business represents less than 50 percent of net premiums written or net loss and loss expense provisions or where the unrelated business net premiums are less than $50 million.

Table 1 reports selected balance sheet data for Class 4 insurance companies required to make public filings by the Bermuda Monetary Authority. Of the 30 Class 4 insurance companies in Bermuda, three have been identified in press reports[30] as hedge fund reinsurance companies.[31] Insurance liabilities represent a small share of total assets of these firms, between 1 percent and 12 percent, which suggests that the companies retain a large surplus. In addition to these companies, four other Class 4 insurers would fail the insurance liability to asset ratio tests proposed in the tax reform staff discussion draft of Senator Baucus (then Chairman of the Senate Finance Committee) and the tax reform discussion draft proposed by Ways and Means Committee Chairman Camp (both described above). These companies have insurance liability to asset ratios of 24.9 percent, 34.7 percent, 32.5 percent, and 30.6 percent, respectively.

The weighted average ratio of insurance liabilities to assets is about 57.8 percent for all Class 4 insurance companies and rises to 59.4 percent if the companies that would fail the test are excluded. While these seven companies account for five percent of all assets, they represent only 2.3 percent of all insurance liabilities of the 30 Class 4 insurance companies.

Table 2 reports selected balance sheet data for Class 3B insurance companies required to make public filings by the Bermuda Monetary Authority. Among the 13 Class 3B insurance companies, only two would fail the insurance liability test, those with ratios of 21.0 percent and 33.6 percent, respectively. The weighted average ratio of insurance liabilities to assets is 56.3 percent for all Class 3B insurance companies.

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[30] See articles in footnote 16 above, which identify PacRe, Ltd., S.A.C. Re, Ltd., and Third Point Reinsurance Company Ltd. as hedge fund reinsurers.

[31] Some companies identified as hedge fund reinsurers may not be included here because they are not required to make their regulatory filings public. Hedge fund reinsurers may wish to assume only enough insurance risk to qualify for the PFIC exception. As such, it is possible that a company may not write more than $50 million of premiums for unrelated business.

Table 1.–Class 4 Bermuda Insurance Companies: Selected Balance Sheet Data As of December 31, 2012 (Amounts in Millions of US Dollars)[1]

	Total Assets	Total Liabilities	Insurance Liabilities	Insurance Liabilities-Assets Ratio
ACE Bermuda Insurance Ltd. and its Subsidiaries	6,478	3,136	2,575	39.7
ACE Tempest Reinsurance Ltd. and its subsidiaries	22,148	11,733	9,982	45.1
Allied World Insurance Company, Ltd	11,686	7,720	6,871	58.8
Alterra Bermuda Limited	8,313	6,205	5,968	71.8
Amlin AG	3,261	1,636	1,605	49.2
Arch Reinsurance Ltd. and Subsidiaries	17,749	12,237	11,743	66.2
Axis Specialty Limited	11,035	6,544	6,465	58.6
Aspen Bermuda Limited	5,297	3,180	3,135	59.2
Catlin Insurance Company Ltd.	14,014	10,558	9,838	70.2
The Chubb Corporation	52,184	36,357	30,324	58.1
DaVinci Reinsurance Ltd.	2,312	814	576	24.9
Endurance Specialty Insurance, Ltd	8,764	5,741	5,317	60.7
Everest International Reinsurance, Ltd.	1,045	617	608	58.2
Everest Reinsurance (Bermuda), Ltd.	8,717	5,671	5,560	63.8
Hannover Re (Bermuda) Ltd.	2,997	1,598	1,597	53.3
Hiscox Insurance Company (Bermuda) Limited	1,894	876	831	43.9
Ironshore Insurance Ltd.	4,739	3,084	2,560	54.0
Lancashire Insurance Company Limited	2,174	806	754	34.7
Montpelier Reinsurance Ltd. and its subsidiary	3,630	1,639	1,181	32.5
PacRe, Ltd.	490	4	3	0.7
Partner Reinsurance Company Ltd	10,177	6,121	5,807	57.1
Platinum Underwriters Bermuda, Ltd	2,349	1,070	1,004	42.7
Renaissance Reinsurance Ltd. and subsidiaries	3,753	1,953	1,838	49.0
S.A.C. Re, Ltd.	568	34	6	1.1
Starr Insurance and Reinsurance Limited and subsidiaries	3,476	1,087	1,065	30.6
Third Point Reinsurance Company Ltd. and Subsidiary	1,349	439	161	11.9
Torus Insurance (Bermuda) Limited	2,684	1,770	1,728	64.4
Validus Reinsurance, Ltd	7,294	3,022	2,613	35.8
XL Insurance (Bermuda) Ltd	43,695	31,835	29,195	66.8
XL Re Ltd	16,183	12,011	11,061	68.4
TOTAL	280,456	179,497	161,970	57.8

Source: Bermuda Monetary Authority and JCT staff calculations.

[1] Data for Hannover Re (Bermuda), Ltd. converted from Euro to US dollars based on IRS exchange rates available at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Treasury-Reporting-Rates-of-Exchange-as-of-December-31-2012.

Table 2.–Class 3B Bermuda Insurance Companies: Selected Balance Sheet Data As of December 31, 2012 (Amounts in Millions of US Dollars)[1]

	Total Assets	Total Liabilities	Insurance Liabilities	Insurance Liabilities-Assets Ratio
American International Reinsurance Company, Ltd. and its	5,075	3,733	3,522	69.4
Assured Guaranty Re Ltd.	3,150	1,848	1,424	45.2
Best Doctors Insurance Limited	60	48	46	76.3
Colonial Medical Insurance Company Limited	69	19	14	21.0
Gard Marine & Energy Limited (Consolidated)	864	598	453	52.4
International General Insurance Co. Ltd.	611	382	373	61.1
JRG Reinsurance Company Ltd.	985	642	640	64.9
Maiden Insurance Company Ltd	3,329	2,136	2,111	63.4
MS Frontier Reinsurance Limited	1,303	459	438	33.6
Nissan Global Reinsurance, Ltd.	2,265	1,563	1,503	66.4
Oil Casualty Insurance Ltd.	1,232	742	535	43.5
Tokio Millenium Re Ltd	2,192	1,019	976	44.5
Wind River Reinsurance Company, Ltd.	1,993	1,093	987	49.5
TOTAL	23,128	14,282	13,022	56.3

Source: Bermuda Monetary Authority and JCT staff calculations.

[1]Data for Colonial Medical Insurance Company converted from Bahamian dollars to US dollars based on IRS exchange rates available at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Treasury-Reporting-Rates-of-Exchange-as-of-December-31-2012.